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THE ELIMINATION OF THE CAPITAL GAINS DIFFERENTIAL FOR INDIVIDUALS AND ITS IMPACT ON SMALL BUSINESS CAPITAL FORMATION

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ORIGINAL
COMPLETED

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

THE ELIMINATION OF THE CAPITAL GAINS DIFFERENTIAL FOR INDIVIDUALS AND ITS IMPACT ON SMALL BUSINESS CAPITAL FORMATION

JUNE 4, 1986

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THE ELIMINATION OF THE CAPITAL GAINS DIFFERENTIAL FOR INDIVIDUALS AND ITS IMPACT ON SMALL BUSINESS CAPITAL FORMATION

WEDNESDAY, JUNE 4, 1986

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SR-428A, Russell Senate Office Building, Hon. Lowell Weicker, Jr. (chairman of the committee) presiding.

STATEMENT OF HON. LOWELL WEICKER, JR., A U.S. SENATOR FROM THE STATE OF CONNECTICUT, AND CHAIRMAN, SENATE SMALL BUSINESS COMMITTEE

The CHAIRMAN. This morning the Committee on Small Business is holding the hearing on the proposed elimination of a capital gains differential contained in the Finance Committee's tax reform bill H.R. 3838 which, incidentally, will be taken up by the full Senate this afternoon.

The committee will explore whether the proposal to eliminate the capital gains differential from our Tax Code will have a damaging effect on the ability of our small and emerging companies to raise capital.

Virtually since the inception of the Federal income tax, Congress has allowed for the differing tax treatment of earned income and gains resulting from investments in capital assets. In part, that differential has been maintained in order to encourage and reward the entrepreneurs and risk-takers of this country.

It is well known that the lion's share of new jobs in our country are developed by young companies who thrive and prosper on their ability to attract and retain capital. It is the new and emerging businesses which offer us our best opportunity of remaining internationally competitive and continuously at the cutting edge with new technologies. If we turn our back on these companies, we are crippling our Nation's ability to grow and prosper.

No one knows for sure what will be the result of the elimination of a capital gains differential coupled with sharply lower personal tax rates. Will investors suddenly flee risky or startup companies in favor of more secure or guaranteed ones? Will the higher tax rate on capital gains mean that venture capital companies will no longer be able to find investors? Is there a better way of taxing capital gains without sacrificing our ability to generate new companies? Finally, who benefits from a capital gains differential and who will be hurt by its elimination?

In anticipation of this afternoon's opening debate on H.R. 3838, I am hopeful that this morning's hearing will shed some light on these questions. I am particularly pleased to welcome as our first witness, a dear friend and a former colleague in the U.S. Senate, Paul Tsongas. We are delighted to have you here with us, Paul.

STATEMENT OF HON. PAUL TSONGAS, FOLEY, HOAG & ELIOT, BOSTON, MA

Mr. TSONGAS. Mr. Chairman and Senator Kerry, let me say it is good to be back in this room again on the other side of the aisle. I would welcome the opportunity to vote on this issue, but in some respects I am glad I do not have to.

The CHAIRMAN. You are just having more fun outside this body, Paul.

Mr. TSONGAS. One of our colleagues was in the cloakroom one day a couple of years ago and I said to him, "What is it like on the outside?"

He said, "You work less and get paid more." I would like to suggest to you that that indeed is the case. [Laughter.]

I will try to be sensitive to the committee's time, and the panel that follows me has been instructed to be equally sensitive for the need for brevity.

There are people who will testify on the statistical and data aspects of this issue. What I would like to raise is the conceptual issue and namely that there is a tax bill that has now passed the committee and is on the Senate floor. One of the goals of that bill is fairness, which is a very worthwhile goal and should be pursued. Simplicity is the other goal that has been talked about, and we all applaud that as well.

The question is whether in fashioning a tax bill if there is room in the process to consider the economic implications, whether that is something that is simply arguing for too much detail.

The third panel which you will hear today will raise two specific economic implications of the differential being withdrawn. One is the impact on startups and whether startups can have access to capital to ever be part of the economic process.

The second issue, which Dr. Hatsopoulos raises, which I think is one that has not been raised before is the issue of growth companies—Thermo-Electron would be an example of that—which sell finance through taking their profits back into the system and using that as a way of continuing the growth. If you then have a situation where one does not have the capacity to sell finance and access to capital, what does that do to growing companies? So it is not just the startups but those growing companies which would have to in essence change their way of operating. The demise of the capital gains differential, in our opinion, has a negative impact on both of those issues.

I am here for a very simple reason. In 1977 Congressman Steiger, as you may recall, introduced the lowering of the capital gains tax. I was in the House at the time and my philosophy at that juncture was if it was pro business, it was something that a good liberal Democrat would vote against.

I vividly remember because the issue at that point was murky; it was not clear whether lowering that capital gains tax would have the impact Steiger was arguing for. So on the substance you could really argue it both ways, since the data was unclear. I vividly remember walking in to a vote—and you know what it is like when people lobby you on the way in—and the Democratic leader who was in charge of me at that time came up to me and said to vote no. I said why? Because it is pro business.

That was supposed to be such an obvious and clear answer that I need not argue the merits beyond that. I found that to be a very compelling argument and voted no. That was in my pre-neo-liberal days I would suggest.

Well, fortunately, I was in the minority and the bill passed. And I did not really think about it very much after that. But what happened was that over time, there began a kind of drum beat in my district where more and more people were telling me that the Steiger bill really had a major impact on their capacity to even start to grow and congratulated me on the fact that Congress had passed it.

Well, I learned not to tell them how I had voted on that particular issue. It got to be such a topic of conversation in the district and over time when I later came to the Senate, that the issue of what the Steiger bill had done to the environment growth was a given. And then in 1984, when I was leaving the Senate at a time of undue honesty and some debate on the floor, I made the statement that the Steiger bill had done more for economic growth in my district than anything that I had done, clearly not something you do in a sober moment of reflection.

I did make that statement. In fact, it is true—not because I wanted to get up and say that. Clearly you don't do that when you are leaving. But, rather, the years of experience in talking to entrepreneurs in my State had led me to that conclusion.

The point is, how do you come out of a State like Massachusetts and your State which is enjoying incredible prosperity—the DEC's and the Thermo-Electrons and all those companies which have given us that prosperity—and look at a bill that may stunt the growth in that realm and not be concerned?

All I am asking—and I think the chairman and Senator Kerry are sensitive to this—is that some consideration be given to that and that we be sure where we are going before we head down that road. I think it is possible to have the fairness and the simplicity of the tax bill, but also have entrepreneurship at the same time. If you can fashion a bill that includes all of those, then I think it will truly be an historic bill that does not have adverse economic implications.

I think that is something that we should all be able to agree on, and if we can do that, then I think we have really done our job. I would submit the testimony for the record, but that is basically the points I wanted to make.

[The prepared statement of Mr. Tsongas follows:]

Having been on your side of the table I appreciate the committee's time constraints and will attempt to be both brief and to the point.

The panel today includes witnesses who are schooled in the technical and statistical aspects of the capital gains/venture capital issue. I will not seek to infringe on their expertise.

Rather, my task is to suggest a conceptual dilemna facing this committee and the Senate. The dilemna is simple -- in the pursuit of fairness and simplicity inherent in tax reform, is there room to consider economic implications? And if there are adverse economic implications, is there room to try and mitigate those consequences?

Fairness is a worthwhile goal. And should be pursued.

Simplicity is also a worthwhile goal. And it should be pursued.

The tax reform bill before the Senate is a remarkable breakthrough -- and will I'm sure, be the subject of countless books and PhD theses. Senator Packwood and his colleagues should be proud of what they have fashioned.

The issue, however, remains.

The demise of the capital gains differential is going to affect entrepreneurship and venture capital formation. It's going to affect the way companies finance their operation and expansion. The impact will be negative.

Does it matter?

A bit of history to explain why I think it does and why I am here to speak on this matter.

In 1977 I was a member of the House of Representatives. It was my pre-neo-liberal days, if you will. My attitude then was that tax measures that helped business were inherently wrong. They shifted the tax burden onto individuals and for that reason should be opposed.

When the Steiger bill came up for a vote I was not clear as to whether lowering the capital gains rate was advantageous to the national good. I was clear however that the business groups wanted it and my liberal Democratic colleagues were opposed. When I walked through the doors to cast my vote, one of my colleagues urged my no vote by damning the bill as "pro-business".

While the arguments about economic expansion made by Congressman Steiger and his allies were intriguing, it all seemed too speculative. And besides, it was going to lower the taxes paid by business.

I voted no.

Fortunately, I was in the minority and the bill passed.

I didn't pay any attention to the issue for some time afterward. But eventually I began to hear a faint drumbeat, that grew louder and louder in my district and in my state.

The drumbeat was to the point. The Steiger bill had helped create an environment where entrepreneurship, particularly in high tech, could flourish.

As the years passed, that "environment" became an accepted fact of life and economic growth resulted.

Was it real? I will leave the quantification to others on the panel. But was it real to those entrepreneurs? It sure was. There was a clear perception of risk and reward, and people responded accordingly.

By 1984 I was so convinced that the Steiger bill had been of enormous benefit to my constituents, that in a moment of undue candor, I stated on the Senate floor that that bill had more to do with the economic renaissance of my congressional district than I had.

That statement received a great deal of attention at the time for reasons of ideological and philosophical pulling and tugging. But the point remains valid.

The boom in Massachusetts is the result of entrepreneurship. And the capital gains differential is part and parcel of that entrepreneurship. It should not be casually cast aside.

What are the long term implications?

As we continue to lose manufacturing jobs, is this the direction we should be moving in?

As the Far East girds itself to snatch away our high tech base, is eliminating the differential in our interest or theirs?

What in fact is our economic policy?

Are we to walk away from the business of encouraging certain investments in the future?

As someone who represented a district and a state that once knew economic oblivion and now enjoys remarkable prosperity maybe I am too sensitive to the need to keep the engine at full throttle. Maybe I remember the bad old days too well and am haunted by them.

Maybe, but I don't think so.

The capital gains differential is a weapon -- a powerful weapon in the battle to be competetive. To unilaterally disarm ourselves of this weapon is a decision of enormous consequence. I don't believe it is justified. I don't believe the case has been made that warrants abandoning known benefits in favor of a speculative future.

The jurisdiction of this committee is a small business community that will be affected. I urge the members to give great thought to the impact that will result if the Senate passes on this issue and that position is sustained in conference.

We can have simplicity, fairness and entrepreneurship. Let us work towards that goal. Entrepreneurship is the engine that moves our economy and the capital gains differential will help ensure that our current and potential entrepreneurs will stay the course.

The CHAIRMAN. Paul, just one question.

Do you have a specific suggestion as to how we might handle this problem? I have read of several suggestions in the last several days and as the problem is increasingly coming to the fore, I was wondering if you had a suggestion as to how this might be handled.

Mr. TSONGAS. That has been a subject of much discussion, as you might imagine, among the panelists. The argument will be for the differential, a meaningful capital gains differential. There are various ways that one can do that. Whether you narrow it to specific groups or whether you include real estate and everyone else is a matter for discussion.

I think the conclusion was that how you fashion it would be left to the Senators. There are as you know amendments that have been proposed, and we would not pick and choose amongst them, but it is the differential that has to be maintained in some reasonable fashion. I know that your staff is looking at one possible approach. There are others.

Our response is when we finish the conference, if the differential is in there, then in essence the job would have been done well. What that process is up to that point is not ours to dictate.

The CHAIRMAN. Senator Kerry.

STATEMENT OF HON. JOHN F. KERRY, A U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

Senator KERRY. Thank you, Mr. Chairman.

Obviously, I join with you in welcoming my friend and predecessor in this job back here. I think it is largely because of Paul's advice and much of what he did within the State that directed me toward the Small Business Committee and his good counsel which helped a lot of us in the State to refocus some of our views and thoughts about some of the relationships that we are discussing today.

Also, I would simply like to remind folks here and make sure the record is clear that Paul was one of the leaders nationally within the Democratic Party in making it clear to a lot of people who had not stopped to get beyond that kind of quick and easy lobby effort that occurred to you on the floor, Paul, that the Democratic Party had to stop and think about its relationship to business and that it had to work out a new way of both espousing as well as understanding that if it did not have a better relationship and understanding of how business works and of the relationship of business to the rest of this community in the things we want to do, a lot of those things are not going to happen.

So, I salute his foresight and courage. I know he took a lot of flack from a lot of people in traditional bases when he did it. It has now come to be probably the mainstream thought of the party, and I think it is largely due to a lot of his courage and foresight that it did.

I would simply like to ask—I guess I am as puzzled as a lot of people around here who are trying to figure out the real relationship between startups and risk-venture capital efforts and return on investment and incentives to put money in certain places and in looking at the breakdown on capital sources of capital income people have put in front of me figures that say that banks and corporations, pension funds—I guess what are the others?—endowments, foundations, and insurance companies, none of which would be affected by the exclusion that we are talking about today provide the vast proportion of capital funding, whereas individuals and families for whom this exclusion would have the direct impact provide only about 21 percent or so. That 21 percent, I gather, costs the Federal Government something like $70 billion.

So the immediate question is, how does one justify that loss of the $70 billion for that marginal demonstrated investment piece of the pie versus the argument that is made by some that it is better put in through the aspects or the mass technology development corporations and other kind of direct tracking venture capital efforts.

I wonder if you would kind of comment on that relationship a little bit.

Mr. TSONGAS. The panel that will follow me will argue the numbers, and the numbers that have been put together are really quite different from those that you have made reference to. The revenue impact on the differential, we would argue is, at worst, $1.9 billion over that period of time.

The second, as to how you fashion the response, you obviously can narrow the differential to certain groups that are concerned with startups. So you need not have a differential that covers everybody in order to get at the particular concern that you have.

Senator KERRY. You think we should narrow it?

Mr. TSONGAS. Again, we are very careful not to argue the approach. We will leave that to the Senators. But clearly the startup issue, if it is taken care of, would certainly please the panel.

As someone who—I also have as you know a real estate development company, and I know that the impact on that is going to be serious. But as a citizen, I would rather have my real estate company have problems and see some of the money invested in real estate go into the manufacturing sector, because you are not going to compete with Japan in real estate; you are going to compete with Japan with startups and existing companies.

The third response would be—and I learned this after the Steiger bill and you will have people on the third panel discuss it—what the impact is on perception and the entrepreneur and what he thinks is going to be his reward down the road and whether incurring certain risks and investing in those risks is worthwhile. I think particularly the panelists who are involved with startups can I think address that particular point.

But I think the numbers that have been thrown around, clearly a lot of the investment does take place in those groups you made reference to—the other group is a large group—but beyond that we think the revenue numbers that have been suggested are way off, and you will hear a lot of testimony about that in the next panel.

The CHAIRMAN. Alan.

Senator KERRY. One last quick question.

In terms of that perception thing—I am hearing a mixed response from people in the private sector, many of whom believe that the reduction of the corporate tax from the 46 to the 33 and the decline in their personal tax across the board from, say—I mean we are really talking about people in a larger bracket when you get into this kind of investment, so you are really going from the 50 or something very close to it down to 27, and those combined tradeoffs they feel excited about in a sense of on both scores there is going to be more cash which means that they are willing to risk something without the gain, particularly knowing that the differential on the gain is only 20 percent versus 27 or 22 effective versus 27, and that in the years they can take that gain and reinvest it and take the income from that reinvestment at 27 percent rather than 50, they will be ahead of where they were, maybe not in the immediate year of the asset sale, but within 5 or 10 years.

Mr. TSONGAS. If one has money to invest—and you have a choice because the return is going to be equal on both sides, whether you invest it in one kind of investment or another—what you are going to end up looking at are issues like risk and liquidity. If I can invest in something which is of less risk—and the startup clearly is risky—and there is more liquidity, I am going to opt out for that option, and I am not going to take my chances on a startup where the risk is great and the liquidity issues are serious.

So what you are doing in essence is providing an environment where the money are going to flow toward those things which are stable and riskless, and that may be fine for the investor but it is not good for the national economy, and the answer is obviously no.

Senator KERRY. I appreciate the answer.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Chairman, I have no questions. I am just delighted to see an old friend and colleague here. Paul, it is a pleasure to see you.

[The prepared statements of Senators Dixon and D'Amato follow:]

United States Senate
WASHINGTON, DC 20510

JUNE 4, 1986

STATEMENT BY SENATOR ALAN DIXON

SENATE SMALL BUSINESS COMMITTEE

THE ELIMINATION OF CAPITAL GAINS DIFFERENTIAL FOR INDIVIDUALS AND ITS IMPACT ON SMALL BUSINESS CAPITAL FORMATION

MR. CHAIRMAN, I AM PLEASED TO PARTICIPATE IN TODAY'S HEARING ON TAX OVERHAUL AND ITS IMPACT ON SMALL BUSINESS CAPITAL FORMATION.

THE SENATE FINANCE COMMITTEE, UNDER THE LEADERSHIP OF OUR ESTEEMED COLLEAGUE FROM OREGON, SENATOR PACKWOOD, HAS PROPOSED A DRAMATIC OVERHAUL OF OUR TAX SYSTEM. THE CUTS IN INDIVIDUAL AND CORPORATE INCOME-TAX RATES, THE ELIMINATION OF THE INVESTMENT TAX CREDIT, THE DEPRECIATION CHANGES, THE IRA PROVISIONS AND THE LOSS OF THE CAPITAL GAINS DIFFERENTIAL ARE SOME OF THE MORE PROFOUND ISSUES ADDRESSED IN THIS BILL. THE COMPLEXITY OF THE BILL IS REFLECTED IN MORE THAN 2000 PAGES OF THE BILL AND ITS ACCOMPANYING COMMITTEE REPORT.

THE IMPACT OF THE BILL ON SAVINGS AND CAPITAL FORMATION IS NOT YET OBVIOUS. CAPITAL FORMATION IS IMPORTANT TO SMALL BUSINESSES, AS THE TESTIMONY DURING THE 14 TAX RELATED HEARINGS CONDUCTED BY THIS COMMITTEE IN 1985 AND 1986 INDICATES.

IN A HEARING I CHAIRED IN CHICAGO, ON MARCH 4, 1985, TESTIMONY WAS RECEIVED FROM E. PATRIC JONES, PRESIDENT OF THE URBAN FUND OF ILLINOIS, MANAGING OFFICER OF COMBINED OPPORTUNITIES INCORPORATED, AND PAST CHAIRMAN OF THE AMERICAN ASSOCIATION OF MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT COMPANIES, WHO SPOKE ON BEHALF OF THE VENTURE CAPITAL INDUSTRY. HE NOTED HOW IMPORTANT THE CAPITAL GAINS DIFFERENTIAL HAS BEEN IN ENCOURAGING INVESTMENT CAPITAL IN BOTH NEW AND EXISTING BUSINESSES.

WITH THE TAX BILL EXPECTED TO BE BROUGHT TO THE FLOOR OF THE SENATE FOR DISCUSSION TODAY, ALL OF US WELCOME THIS OPPORTUNITY TO HEAR FROM SMALL BUSINESS PEOPLE AND THEIR REPRESENTATIVES, AS THEY SET FORTH THEIR VIEWS ON THE IMPACT OF THE BILL ON CAPITAL FORMATION. THEIR TESTIMONY WILL HELP US SHAPE OUR DECISIONS AS WE CONSIDER THIS IMPORTANT LEGISLATION.

I LOOK FORWARD TO PARTICIPATING IN TODAY'S HEARING.

STATEMENT BY SENATOR ALFONSE D'AMATO
COMMITTEE ON SMALL BUSINESS
JUNE 4, 1986 9:30 AM SR - 428A

MR. CHAIRMAN, AS THE SENATE BEGINS TO DEBATE THE MOST RADICAL TAX BILL IN RECENT HISTORY, I COMMEND YOU FOR HOLDING THIS TIMELY HEARING ON THE ELIMINATION OF THE CAPITAL GAINS DIFFERENTIAL FOR INDIVIDUALS AND ITS IMPACT ON SMALL BUSINESS CAPITAL FORMATION. SINCE THE ADOPTION OF THE INTERNAL REVENUE CODE THERE HAS BEEN A DIFFERENTIAL BETWEEN TAX RATES ON ORDINARY INCOME AND CAPITAL GAINS; THIS DIFFERENTIAL PROVIDES THE NECESSARY INCENTIVE TO ATTRACT CAPITAL TO NEW OR HIGH RISK BUSINESSES.

IN 1983, PROFESSIONAL VENTURE CAPITAL FIRMS INVESTED AN ESTIMATED $2.8 BILLION TO START NEW BUSINESSES AND TO FINANCE THE CONTINUED GROWTH OF YOUNG COMPANIES. THESE INVESTMENTS HELPED CREATE NEW JOBS, IMPROVE TECHNOLOGY AND PRODUCTIVITY, AND INCREASE INDUSTRY COMPETITIVENESS. THIS GROWTH IS DIRECTLY RELATED TO THE LOWERING OF THE MAXIMUM CAPITAL GAINS TAX FROM A HIGH OF 49% IN 1976 TO A LOW OF 20% IN 1981. THE CORRELATION BETWEEN THE CAPITAL GAINS TAX AND VENTURE

INVESTMENT IS OBVIOUS - INVESTMENT INCREASES AS THE CAPITAL GAINS TAX DECREASES.

CAPITAL FORMATION IS EXTREMELY IMPORTANT TO NEW FIRMS. IT PROVIDES THE INCENTIVE FOR ENTREPRENEURS TO STRIKE OUT ON THEIR OWN AND TO TURN AN IDEA INTO A THRIVING BUSINESS. THIS ACTIVITY SHOULD CONTINUE TO BE ENCOURAGED. I AM LOOKING FORWARD TO HEARING THE TESTIMONY OF OUR DISTINGUISHED PANEL OF WITNESSES TODAY, AND I HOPE THAT THEY CAN SHED ADDITIONAL LIGHT ON THE CAPITAL GAINS TAX DEBATE.

THANK YOU, MR. CHAIRMAN.

Mr. TSONGAS. Let me say I am impressed with your seniority. [Laughter.]

You were not sitting there when I was here.

The CHAIRMAN. Paul, thank you very much for your testimony. Let me say, as I have said privately many times, of all the ladies and gentlemen I have known in the U.S. Senate, you rank among the greatest Senators.

Mr. TSONGAS. I will tell that to my wife when I get home. [Laughter.]

Senator KERRY. I was told you already had. [Laughter.]

The CHAIRMAN. The first panel consists of Mr. Burton McMurtry, partner, Technology Venture Investors, in Menlo Park, CA; Mr. Stanley E. Pratt, chairman of Venture Economics, Wellesley Hills, MA; and Mr. Walter Stults, president of the National Association of Small Business Investment Companies here in Washington.

Gentlemen, it is nice to have you all. Make yourselves comfortable. We will proceed in the order in which I called the panel.

Mr. McMurtry.

STATEMENT OF BURTON J. McMURTRY, PARTNER, TECHNOLOGY VENTURE INVESTORS, MENLO PARK, CA

Mr. McMURTRY. Thank you, Mr. Chairman. It is a pleasure to be here, and I have submitted some written testimony. I would like to make some brief remarks and then respond to questions, after the other gentlemen have had a chance to speak.

The National Venture Capital Association has been a supporter of the tax reform movement in general and in fact feels that there are many very positive aspects to the current Senate bill. We feel that there is one significant mistake in it, and that is that the capital gains differential has been removed. We believe that that is a significant error and that the differential should be restored.

The consequences of reductions in capital gains taxes beginning in 1978 have now been pretty well documented and those consequences are: Significant creation of jobs, significant creation of additional tax revenues, creation of productivity improving products, improvements in exports, and a number of improvements in the general quality of life.

There is also a GAO study which was done in 1982 and in that study of 1,332 companies that were started between 1970 and 1979 it turned out that on the average, for $1 million invested in each of those companies, their estimate is that by 1989 the taxes paid by the average company will be $5 million and the number of jobs created is about 1,400. So very, very significant things.

We will also hear from Stan Pratt about a study that has just been done and is being announced today by Venture Economics which also is new information but confirming information about the importance of risk capital and the leverage that exists in the risk capital process to produce jobs.

The revenue impact of restoring the differential, we believe, is very small. That will be addressed later in the panel. But the number that we believe is reasonable is a number on the order of $1.9 billion of potential revenue gain over 5 years. I personally am not convinced that it would be positive; I think that very well could be a negative number.

Let me go for a moment and say why is the differential so important? It is related to Senator Kerry's question about are low rates not enough to produce the result that you are looking for and are not low rates, coupled with removing a lot of unproductive investing in shelters and so on, is that not enough to do the job?

Our view is that it really is not enough to do the job. We think that the Tax Code is not sufficient—the current Tax Code is not sufficiently biased toward investment, and that the results of risk investing and investing in growth companies are so positive for the economy that we believe the Tax Code should be biased in a direction to encourage that behavior.

We also believe that investors and entrepreneurs and potential employees of growth companies are very sensitive to signals, and a signal that increases the capital gains tax and eliminates the differential we think is exactly the wrong kind of signal that one should be sending.

What are the impacts on entrepreneurs and other people? There is a diehard group of entrepreneurs who will start companies anytime. I mean, they simply have to be starting companies and we applaud them; they're wonderful people. They're around.

There is a much larger group of people who are more rational about whether or not they should be starting a company and if risk capital is readily available, they may do that; if it is not, they will not.

It is also very important that growth companies have access—not just the senior management people, although that is very important—but to employees of all kinds who are needed to provide and manage the growth of those businesses. The bulk of those people come, almost by definition, from larger companies. The ability to attract those people has been very much related in the past to the capital gains differential and the carrot that is there in the form of a potential capital gain on their equity that justifies their taking lower salaries which have to be paid by smaller companies.

We are already seeing some disturbing trends in the inability to get people to move from larger companies to smaller companies for some very interesting growth opportunities. That is very good for the larger companies; it makes it much easier for them to keep their people. I do not think, on balance, that that is good for our economy.

I should add that some of my friends in the venture capital business are actually very comfortable with the Senate bill as it stands. In particular, they like the fact that the capital gains differential has been eliminated and that the capital gains tax has been raised. Their feeling is that that will slow the flow of money into the venture capital business, and since they have got theirs, they're very comfortable with that. Also since they have made a lot of money, those who have been in it for a long time and have done well, they really like this, dramatically lowering of the rates is very good.

I have asked a few of them who have told me that they really are happy with this. I have asked, how much of your freed-up capital are you to be putting into risk investments? They say, well, we are going to stay in the venture capital business, of course, but we are not going to go out of our way to look for other risky investments. That would be silly to do under the new system.

The National Venture Capital Association does not share that view. We are trying to take and are taking a much broader view, and that is, we really need a climate for entrepreneurship and innovation and further growth of companies that has been produced by the capital gains differential and by low rates and that we think can be continued by that.

Let me comment on the distribution effect, also. There has been a lot of discussion about the fact that a substantial portion of individual capital gains taxes are paid by wealthy individuals or at least by individuals with high income. I think if you get overly focused on that, you are focused on the wrong issue and you are risking cutting off your nose to spite your face, in that one has to look at the consequences of risk investing. The consequences which, again, have been stated often are so enormously positive that we should do everything possible to encourage long-term investment behavior on the part of corporations and on the part of individuals, as well.

I also have a personal bias that says I would like to see wealthy individuals—high-income individuals—paying even more capital gains taxes. I think we should be encouraging them to put more of their money into really capital and growth-producing assets.

Finally, I should comment briefly on the nontaxed investor issue. Stan Pratt and others will be talking about it a little more. It is true that a substantial chunk of the flow of money into the venture capital business comes from either nontaxed or preferentially taxed institutions or individuals.

An important point, though, is that the very earliest stage of the venture capital business and the risk capital business is the startup phase, the seed capital phase, and the bulk of that money comes from individuals who are very sensitive indeed to tax rates and to the differential. The rest of the process depends upon the issue of whether or not these companies are being started.

Let me not take further time. I would just like to thank the committee, first of all, for holding the hearing, and encourage the committee to be as constructive as possible, in trying to restore the differential. Thank you very much.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. McMurtry follows:]

NATIONAL VENTURE CAPITAL ASSOCIATION

Office of Executive Director:
1655 North Fort Myer Drive
Suite 700
Arlington, VA 22209
703/528-4370

Office of Legislative Counsel:
1050 17th Street, N.W.
Suite 810
Washington, D.C. 20036
202/887-5599

STATEMENT OF

BURTON J. MCMURTRY, PRESIDENT

NATIONAL VENTURE CAPITAL ASSOCIATION

BEFORE THE

SENATE COMMITTEE ON SMALL BUSINESS

JUNE 4, 1986

Mr. Chairman and Members of this distinguished Committee.

I'm Burton J. McMurtry, General Partner of Technology Venture Investors (TVI) of Menlo Park, California. TVI, founded in 1980, is a venture capital partnership specializing in financing startups and rapidly growing technology-based companies in the western U.S. TVI manages about $150 million for 15 institutional investors. I entered the venture capital business in 1969 and have financed over 80 companies, including Archive, Cadnetix, Collagen, KLA Instruments, Microsoft, NBI, Rolm and Sun Microsystems.

I am appearing before you this morning in my capacity as President of the National Venture Capital Association (NVCA). NVCA is an association of over 200 venture capital firms and represents over 70% of the identifiable professionally-managed venture funds in the United States.

We are here to give you our assessment of the effect of the Senate Finance Committee Reported Bill on small businesses and on the venture capital industry. Most features of the Bill are very positive, especially the lowered maximum tax rates on ordinary income for corporations and for individuals, and the preservation of a capital gains differential for corporations. We were, however, startled and disappointed to find that the Bill eliminates the differential between the tax rates on capital gains and ordinary income for individuals and increases the maximum individual capital gains tax by at least 35%.

We strongly believe that the individual capital gains differential and lowered capital gains tax rates have been enormous stimuli to the availability of risk capital. The surge of venture capital since the 1978 and 1981 capital gains tax rate reductions is well documented. (See, for example, Stan Pratt's testimony today.)

It would be overly simplistic and probably wrong to take the position that the only factors driving venture capital availability are the tax rate on capital gains and the differential between tax rates on capital gains and ordinary income. It would be even more foolish to ignore such strong phenomenological evidence and argue, as some do, that capital gains tax rates could be raised and the differential eliminated without significant disruption to the number of startup companies and to the flow of equity capital to growth companies.

The tax revenue benefit of restoring a meaningful capital gains differential is likely to be small indeed. Today's testimony from Tom Vasquez indicates that the five year impact of increasing the capital gains rate to 27% versus keeping it at 20% might be as large as a $1.9 billion revenue gain. My personal estimate is that the increase to 27% would actually lose revenue.

Why do we believe the differential is so important? First, we believe that most investors are pretty rational and are good at reading "signals" Under current law an investor pays a maximum tax rate of 50% on ordinary income and 20% on long-term capital gains. This differential of 30% in tax rate is a distinct "signal" that investment is favored. We are not apologetic about this bias toward investment in current law. On the contrary, we believe that current law is not sufficiently biased toward investment, i.e, there should probably be an even greater differential between the rates and that should be achieved by lowering capital gains tax rates.

One can argue that any tax on capital gains or dividends on corporate securities represents a clear case of double taxation. These arguments were made effectively in the final report of the President's Commission on Industrial Competitiveness.

U.S. industry and the U.S. capital market have often been accused of being much too focused on the short term and not sufficiently focused on the long term. The much longer-term view in Japan has been very instrumental in its penetration of many markets previously dominated by U.S. suppliers. Entrepreneurship and venture capital have been major U.S. weapons in the battle to take a longer-term view. Venture-backed growth companies are not on the quarterly earnings treadmill forced on public companies, and officer compensation is not focused on bonuses related to short-term performance.

Our economy is too short-term oriented already, and removing long-term investment incentives will only exacerbate the problem.

But let us return to the importance of the differential. Investors, entrepreneurs, managers and employees of small and rapidly growing companies are well aware of the current 20% vs. 50% differential. If you change that relationship to 27% vs. 27%, we believe you will produce an undesirable result, namely, a general aversion to more risky investments, especially early-stage venture capital investments which are highly illiquid for many years. Remember that the average time to achieve any realizable (i.e., liquid) gains in a venture investment is 4 to 6 years, and that during that time the investor has no practical choice but to hold onto that security which produces no income from dividends or interest. This new disincentive toward long-term investment will apply not only to professional venture investors, but will also affect the multitude of individual investors who help start and grow America's small businesses. If the flow of risk capital slows, the consequences are familiar: fewer startups, fewer jobs, lower tax revenues, and a weakened international competitive position.

It is true that lowering the maximum tax rate on ordinary income from 50% to 27% coupled with the elimination of non-productive shelters should produce lots of additional dollars for productive investments. But how many of these dollars are likely to flow into risky, illiquid, long-term investments? We are besieged by arguments in the press that there will be plenty of risk investment as long as the potential returns are sufficiently high, and that further incentive via a capital gains differential is neither necessary nor desirable. We simply disagree with that view.

Our view is that the positive results of risk capital investing are so clear for the country that we shouldn't be experimenting with the policies that might throttle risk investing. Rather, we should encourage risk investing in every way possible, especially by legislating low capital gains tax rates and a significant differential.

What about the attitude of entrepreneurs? Fortunately, there are many who are so committed to starting and growing businesses that they are practically oblivious to tax policy and most other external circumstances. Thank God for these diehards: they even started companies between 1970 and 1977. The diehards will certainly not be discouraged by the current tax proposal.

Unfortunately, there are many entrepreneurs and even more prospective growth-company employees who are more rational and whose decisions are influenced by issues such as tax policy. Some of them are already reading clearly the signals in the proposed tax plan. This is most evident in trying to recruit employees from larger, mature companies to join startups and rapidly growing companies. Under current law the prospect for a large capital gain taxed at 20% vs. continuing high salary taxed at 50% makes it attractive for an employee to take a risk with a smaller company. The proposed 27% rate for all income makes it more desirable for the employee to remain with his or her large, mature company. That makes life much easier for the current employer, but it is a real problem for growth companies. Inability of growth companies to attract qualified employees to produce and manage growth is at least as serious a problem as lack of capital for those same companies.

The elasticity in the supply of entrepreneurs was amply demonstrated after the 1978 capital gains tax reduction. As huge amounts of money began to flow into the venture capital business after 1977 most of us who had been in the business for some time felt that there would be "too much money chasing too few deals". What we found was that entrepreneurs were coming out of the woodwork, i.e., they were reacting rationally to the very real incentives provided by the capital gains tax reduction and the large differential.

It is true that we overinvested in certain industries, e.g., personal computers and disk drives. But what were the negative consequences of that overinvestment? Venture capitalists simply lost a lot of money, but the surviving companies tended to be stronger than they would have been if they had grown up in a less competitive environment. In other words, venture capitalists have had to learn how to operate in a really competitive environment. That cannot be bad for the country, although it has been pretty tough on a lot of venture capitalists.

In fairness I should state that some established venture capitalists would be very pleased to see the capital gains tax rate increased to 27% from 20% and the differential eliminated. They believe that the flow of venture funds will be slowed, but that's good for them since the business will become less competitive than it's been since 1978. Further, they have well-established money sources and some have large incomes and assets that would benefit substantially from the decrease in the maximum ordinary income tax rate from 50% to 27%.

The NVCA leadership believes we should not take such a narrowly self-interested view. Venture investment has been a major driving force behind the development and growth of many industries, including electronics, computers, biotechnology and medical products. The results have been impressive on many fronts: job creation, productivity improvement, tax revenue enhancement, improved U.S. competitiveness, and improvements in the quality of life. The U.S.' performance in these areas is envied by the rest of the world. We should take no steps that might discourage the process. Rather, we should make life easier for entrepreneurs and growth companies and make it tougher (more competitive) for the venture capitalists. The country will be the winner.

Let's work to restore the capital gains differential and keep low capital gains tax rates!

I thank you for your attention and would welcome your questions.

The CHAIRMAN. Mr. Pratt.

STATEMENT OF STANLEY E. PRATT, CHAIRMAN, VENTURE ECONOMICS, INC.

Mr. PRATT. Thank you, Mr. Chairman, and members of the committee. I am Stan Pratt. I am chairman of Venture Economics, Inc., which is a research and consulting firm in Wellesley, MA. I publish the "Venture Capital Journal," and the "Guide to Venture Capital Sources," and we follow some 7,000 U.S. companies that have been backed by professional venture capital. I am very pleased to have the opportunity to be here today because I sincerely believe the proposed elimination would be a major setback for the Nation's business development process.

Our international competitiveness, in my opinion, would be seriously jeopardized since, first, these companies are the ones that are providing most of the front wars in the new export sales business; and, second, our international competitors are now building our entrepreneurial environment to an extent that many of us are going to be very surprised very quickly. I'll comment a little bit more about that later.

Since we have seen a great deal of data that lower capital gains taxes have actually provided greater tax revenues, it would appear that the only real reason for the proposed elimination is to not provide as much of a tax break for the very wealthy investors. In my opinion, the differential is not a tax shelter to preserve and protect the wealthy but, in fact, it is a reward for the risks and time requirements in new business development.

The elimination of the differential is really a slap in the face to those who would create wealth and not a hinderance for the protectors of wealth. I think the elimination would hamper the social mobility for the many hundreds of middle-class people who joined with people such as Steve Jobs in creating Apple Computer. Remember that that company, I believe, created something over 100 new millionaires among just the employees of the company, officers and employees.

So the capital gains tax differential—hitting on a point that Burt brought out—also enables these small companies to attract the managers that they need. Most people do not understand that the people that run these small businesses are not inventors who have been tinkering around at their desks. They are basically managers who have some understanding of rationality in deciding what their career paths are going to be. So it is very important that we are able to attract those people.

The venture capital industry has had remarkable growth since the reestablishment of the capital gains tax differential in 1978. I prepared a chart over here that basically shows you what really happened, and it's quite dramatic. We went from $171 million in new capital in 1969 down to the grand amount of $10 million in 1975. They passed the differential in 1978, and we had $600 million of new capital into the industry in that 1 year alone; that is more than the $466 million, which was the total of the 8 prior years.

The CHAIRMAN. You want to bring that chart out? It is a little distant. Could you bring it closer?

Mr. PRATT. It is also part of my written testimony, which I would like to have entered into the record. That is chart 1.

The CHAIRMAN. Just right there in that corner so we can see it.

Mr. PRATT. There is a question sometimes raised, by the way: How did we get $600 million in in that 1 year, 1978, when the capital gains tax reduction did not go through until October? The fact was we came down here for the NVCA meeting in May and were told that we had 65 Senators cosponsoring a bill. Now that gave us some feeling it might pass. And with that, we went back and talked to our people and the taxable investors provided most of that initial money. Most of the money thereafter in the one sector, and I will deal with that in a moment, comes from nontaxable investors.

Did you want to ask questions now, sir?

The CHAIRMAN. No; I just wanted to be able to see what you were referring to.

Mr. PRATT. By the way, I want to mention one thing that is quite interesting to me, and that is I do not know how many of you might remember, but many of us view that the turning point in that successful battle in 1978 was testimony before this very committee when Ed Chow, who is now running and maybe he would like to get on this committee in the next year or so, testified before this committee on February 8, 1978. That was the start of our success in getting the capital gains tax lowered and the differential reestablished.

There has been much comment—and we have already had it from Senator Kerry and others—that much of our industry comes from nontaxable sources. First, I want to ask you to be very careful with my numbers. I am not too happy about being roasted on my own petard. The fact is that the numbers that you see, when we talk about the bulk coming from nontaxable sources, are only of one segment of the industry, that is the independent venture capital funds. The other two segments, which are a total of $5 billion of the $19 billion process—excuse me, $5.5 billion—are all taxable. Virtually all small business investment companies are taxable and most are funded by individuals, I think you will bring out, and institutions who are taxable, not nontaxable institutions.

Senator LEVIN. Where is that $5.5 billion, if I could just interrupt for a second. I do not see it on here.

Mr. PRATT. It is not on this chart, sir. We are leading into now one that I did not—if you look in here, the size of the total pool is $19,600 million at the end of 1985.

Senator KERRY. Let me just inquire. They are taxable as corporations, are they not?

Mr. PRATT. In part. Some are taxable as corporations and some are taxable as individuals.

Senator KERRY. Do you know the breakdown?

Mr. PRATT. I do not. Mr. Stults may have it from the viewpoint of the SBIC, which is approximately $2 billion of that $5 billion.

If we look at the total number, you will see it as part of my testimony, approximately 65 percent of the $19 billion employed in our industry today is from taxable U.S. domestic investors, both corporate and individuals. So it is not just individuals; 65 percent of that $19 billion is, in fact, taxable. It's about one-third of only the $12 billion in the independent private funds that is nontaxable.

I think a point that Burt made is extremely important to follow up on also and that is that taxable investors are always the leaders. A pension investor or a nontaxable investor generally has a fiduciary obligation and they tend to be followers, not leaders, into new investment areas. Therefore, we depend upon the leaders being the taxable investors, and that's what happened earlier.

We also hear a great deal that tax shelter being eliminated under this new proposal would provide money. Again, I vehemently disagree. Tax shelter investors seek to eliminate risk by return of capital from tax savings, they are not the sort of people who will take risk and take the long-time commitment to build new businesses. Young businesses require growth-oriented investors.

Burt referred to the fact that we had a new study to complement the GAO study. Some of you may know that we provided data for the General Accounting Office in that study that was done in 1982. Our new study we did on our own and have found that the data is very similar but even more interesting because we have done it on 405 companies, whereas the data that the GAO did it was on only 72 firms. We found that it is really very similar.

To give you some idea, we have found that it can be expected that these young growth companies can produce about 118,000 jobs by year 12 of their lifetime. We have found that they spend very disproportionate amounts in research and development. A hundred of those would spend about $500 million by year 12, and that they would pay some $700 million in Federal taxes by year 12.

The data on these young companies were also looked at as to how they were capitalized, and this is extremely important and will tie in with testimony you will hear from two other people that will follow me—that is, they require continuous injections of outside capital as they are young and growing. Later on they are able to use retained earnings. Large companies generally like this new proposed bill because they are able to retain more of their retained earnings. Not all of them, but many of them will go for that. The nongrowth companies really like the bill. The growth companies still do not like it because they have to reinvest all of their earnings.

The United States now is viewed as the world leader in entrepreneurial activity. I think there are two points that I want to make on this. One is that two of our most serious international competitors—Germany and Japan—have no taxation for individuals on long-term capital gains—zero for individuals. Many countries are now trying to build an entrepreneurial environment similar to ours. It may surprise you that I believe one of the most successful at this is going to be Japan.

I was in Japan last year and had over 500 potential entrepreneurs come to hear me speak on how you build new businesses in the United States. They want to try to get much more entrepreneurial in Japan. Let me tell you, I think they are making remarkable progress.

I must close with a rather sad commentary. The day after the proposed Senate Finance Committee elimination of the gains was announced, I received a call from a European client. His comment could be paraphrased as follows:

You Americans are so predictable. When you have everything going your way and the world's most enviable environment for entrepreneurship and new business development, your Government tries to undo it. You always seem to be intent on destroying everything you do well.

Eight years ago our efforts to restore the capital gains differential and lower the maximum tax rate started to achieve success in hearings before this committee. Let us hope that history will repeat itself.

I thank you for your attention and welcome your questions.

The CHAIRMAN. Thank you very much, Mr. Pratt.

[The prepared statement of Mr. Pratt follows:]

STATEMENT OF
STANLEY E. PRATT
CHAIRMAN, VENTURE ECONOMICS, INC.

BEFORE THE
SENATE SMALL BUSINESS COMMITTEE

JUNE 4, 1986

Mr. Chairman and Members of this distinguished committee.

I am Stanley E. Pratt, chairman of Venture Economics, Inc., Wellesley Hills, Massachusetts, a consulting and information services firm specializing in the new business development process. I am also publisher of Venture Capital Journal, a monthly publication that has been following the activities of venture capital firms and the companies they have financed since 1961. As editor of the 10th Edition of Pratt's Guide to Venture Capital Sources, I publish a book annually to assist entrepreneurs in their dealings with the venture capital process. Through computerized databases, Venture Economics maintains extensive data on venture capital and the entire process of new business development. Our principal database includes more than 7,000 U.S. companies financed by venture capitalists. Our products and services are provided to a broad range of corporate, institutional, investment and governmental clients. These activities are both national and international in scope. We have also provided data and testimony for government groups, as well as background for the national and international media.

Venture Economics, Inc. was the principal contractor supplying the data incorporated in the U.S. General Accounting Office, August 12, 1982, report on the venture capital industry to Senator Lloyd Bentsen, then chairman of the Joint Economic Committee.

Prior to purchasing and assuming the management of Venture Economics, Inc. (then Capital Publishing Corporation) in 1977, I had more than 20 years experience in investment banking, management consulting for small businesses and venture capital.

I am pleased to have the opportunity to appear here today since the proposed elimination of the capital gains tax differential for individuals by the tax reform bill reported by the Senate Finance Committee would be a major set-back for this nation's business development process. In addition, our international competitiveness would be jeopardized since the innovative young companies most directly affected are major suppliers of export sales and our international competitors are striving hard to build entrepreneurial environments to match ours.

There has recently been much confusion in the national media as well as a lot of misunderstanding as to the impact of the elimination of the capital gains tax differential. I welcome this chance to clarify some misconceptions and to present my views.

It is important to understand that the business development process is really driven by the perceptions of entrepreneurs. Investors and venture capitalists cannot push a string, they provide the capital, support and guidance that often enable the entrepreneur to be successful. The perceived climate, or environment, that will affect the risks and rewards of new business development is a major influence on both entrepreneurs and investors.

Since the increase in capital gains tax collections after the 1978 capital gains tax reduction is widely recognized, the only apparent reason for the Senate Finance Committee's elimination of a differential was to avoid too great a tax reduction for the wealthy. In fact, the capital gains tax differential is not a tax shelter to preserve and protect wealth, but rather a reward for entrepreneurs for the enormous risks and substantial time commitment required for successful new business development.

The elimination of the differential then is a slap in the face to those who would create wealth rather than a hindrance for the protectors of wealth. In effect, the elimination would hamper the most powerful instrument for social mobility in our economy -- not just for the well known entrepreneurs such as Steve Jobs (Apple Computer), but also for the many hundreds of middle-class employees who joined in his efforts and shared in his success. The capital gains tax differential has enabled young businesses to compete with large corporations for critically needed management talent by making incentive stock option plans attractive to offset their inability to match high salaries.

The principal role of the venture capital profession is to provide the capital together with the value-added guidance and support that is so critically needed by the young entrepreneurial management team. As you are well aware, the venture capital industry has had remarkable growth in the past eight years since the reestablishment of the capital gains tax differential in 1978. I should note, parenthetically, that the turning point in that successful battle is considered by many of us to have been the testimony of Dr. Edwin Zschau, now Representative Zschau, before this Committee on February 8, 1978.

As indicated in the attached Charts 1 and 2, the flow of new capital committed to venture capital firms was clearly stimulated by the 1978 capital gains tax decrease and the reestablishment of the differential. After dropping from $171 million in 1969 to only $10 million in 1975, the inflow of $600 million in 1978 was greater than the $466 million total for the prior eight years when the maximum capital gains tax rate was being increased and the differential eliminated. The current $19.6 billion pool of capital managed by professional venture capitalists completely overwhelms the $2.5 billion to $3 billion pool available throughout most of the 1970s.

Charts 1 and 3 show that the favorable climate and the availability of capital provided a wealth of opportunities for entrepreneurs and investors as indicated by the investment of more than $14 billion during the past eight years. Incentives are relevant because entrepreneurs and investors perceive them to be necessary to compensate for the risk and time requirements. How can any of us ignore the sterility of new business development from 1969 through 1977, when there was no effective differential.

There has been comment in the media that, since much of the investment capital committed to venture capital firms comes from non-taxable sources, tax incentives are irrelevant. First, it should be noted that 65%, or $12.7 billion, of the venture capital investment pool is from domestic taxable sources. If one considers informal venture investments from taxable individuals, which some analysts estimate to be of the same magnitude as the organized activity, taxable investors are dominant. Second, taxable investors are the leaders in creating a favorable environment for investment activity. The vast bulk of our nation's capital resources, pension funds with strong fiduciary responsibilities, must be followers into areas of perceived investment opportunities. The signal that is being sent out by government by eliminating the tax differential must certainly be perceived as a negative influence on the investment environment.

There has also been much comment that the effective elimination of tax shelters should free up substantial additional capital for venture development. My experience indicates, however, that this would not be the fact. Tax shelter investors are 180 degrees out of sync with venture capital investors. The former are primarily interested in preservation of capital, by paying less taxes, rather than in growth of capital by taking risk and assuming long-term investment orientation.

Tax shelter investors seek tc eliminate risk through an immediate return of capital from tax savings. They are indicative of the instant gratification syndrome that permeates our nation's investment markets. This is the trading mentality that has eroded the long-term performance of most investors.

The secret of successful venture capital investment is a long-term perspective, which achieves reward from building companies that create permanent new value. Under the Senate Finance Committee's proposed tax program, I feel that most former tax-shelter investors will invest in tax-exempt bonds or in relatively low risk income producing investments that would be taxed at the same rate as high risk growth investments.

Young growing businesses require ongoing injections of investment capital from their venture investors. As you will see from the Venture Economics' study on the Economic Impact and Capitalization of Venture Capital-Backed Companies, attached as Exhibit 1, these companies must depend on increasing stock and paid-in capital to finance growth. They need growth oriented investors willing to provide ongoing support, not risk averse tax shelter providers.

The economic impact of the relatively few companies that are able to attract venture capital and achieve success is a very important consideration. The 1982 GAO report for the Joint Economic Committee that I referred to earlier was originally undertaken to examine the impact of venture capital-backed companies on productivity increase. The results of the study showed that 61% of venture capital investment during the 1970s was in companies whose products and services met the GAO's definition of productivity increase. Further examination of companies financed by venture capitalists in the past five years indicates that over 80% of this more recent investment was in productivity improvement related companies.

The most noteworthy conclusion of the GAO report, however, was that the benefits to the nation's economy and productivity were disproportionately large when compared with the amounts of capital invested. From the examination of only 72 firms in which venture capitalists had invested only $209 million during the 1970s, the GAO reported the following economic benefits:

o	Combined annual sales in 1979	$6 billion
o	Annual sales growth rate 1975-1979	33% per annum
o	Estimated jobs created	130,000
o	Corporate tax revenues	$100 million
o	Employee tax revenues	$350 million
o	Export sales	$900 million

The total investments made by professional venture capitalists during the 1970s, when these 72 companies were developed, was $4.5 billion of which $1.6 billion was in 1978-1979. In the 1980s, after the 1978 capital gains tax reduction and reestablishment of the differential, this investment was more than $12.7 billion.

Venture Economics' recent study on the Economic Impact and Capitalization of Venture Capital-Backed Companies, which we are pleased to release coincident with these hearings, confirms and expands upon that data. In this study, Venture Economics focused on 405 companies founded 1968 to 1980 which received venture capital financing and examined employment, revenues, corporate taxes, research and development expenditures and employee Federal taxes. We gathered data to view the progress of these companies at years three, six, nine, twelve and fifteen of operation. We also studied capitalization data for 92 of these companies, a smaller sample due to the difficulties of gathering detailed interim financial information.

The study is attached hereto as Exhibit 1 and a few of the key points are as follows:

- These companies experience rapid growth
- They generate increased employment
- They spend disproportionate amounts on Research and development
- They generate substantial tax revenues

These young growth companies provide the following benefits per 100 companies by year 12 of their lifetime:

Revenues	$7.7 billion
Employees	117,900
Research and Development	$500 million
Corporate Taxes	$420 million
Employee Federal Taxes	$310 million

The data on how these companies were capitalized as they developed shows that they require ongoing investment in equity capital to support their early growth. While lower corporate tax rates would help mature companies with significant internally generated cash flow, an increase in capital gains tax rates and elimination of the capital gains tax differential would severely disadvantage young developing companies.

The United States is currently viewed as the world leader in the entrepreneurial activity that brings about vibrant economic activity. Two of our most serious international competitors, Japan and Germany, however, have no taxation for individuals on long-term capital gains. A number of countries, most notably Japan, are developing technologies on a par with ours in the U.S. Many countries are now trying to build an entrepreneurial environment emulating ours. It might shock you to know, that to my own personal surprise, more than 500 current and potential Japanese entrepreneurs attended a series of meeting with me in Japan a year ago. The Japanese understand the importance of entrepreneurs and seem to be making remarkable progress.

Finally, I would like to comment on an important new trend that is just beginning to have some influence. Large corporations are learning how to work with young innovative companies for the first time. This means that we now have the potential to greatly increase the economic impact of young growth businesses. Through strategic partnerships, small company innovators help large businesses to adapt and employ their own technologies, often through their own marketing and distribution channels. Thus, entrepreneurs not only keep large companies sharp with innovation, but they can also improve the productivity of mature businesses.

I sincerely hope that my testimony and the data provided will help you understand the critical importance of a differential between taxation on ordinary income and long-term capital gains. The extraordinary new business development activity since 1978 compared with the lean times after the 1969 capital gains tax increase and elimination of the differential must be viewed as indicative of a favorable versus an unfavorable environment for new business development.

I must close with a rather sad commentary. The day after the proposed Senate Finance Committee elimination of the capital gains tax differential was announced, I received a telephone call from a European client, whose comment can be paraphrased as follows:

> You Americans are so predictable. When you have everything going your way and the world's most enviable environment for entrepreneurship and new business development, your government tries to undo it. You always seem to be intent on destroying anything you do well.

All of us must be in favor of meaningful tax reform. Why, however, must we put roadblocks in the way of the brightest sector of our economy? When even the Treasury department's own numbers indicate greater government revenues from the lowering of capital gains taxes, why risk entering another period of stagnation by raising capital gains taxes and eliminating the differential? When our investment markets are now almost totally dominated by short-term traders versus the long-term builders, why take away the one remaining reward for patience?

I do not seek special tax considerations for venture capitalists. I do seek recognition and reward for anyone who is a builder, rather than a trader.

Eight years ago, our efforts to restore the capital gains tax differential and lower the maximum tax rate started to achieve success in hearings before this committee. Let us hope that history will repeat itself.

I thank you for your attention and welcome your questions.

Chart 1

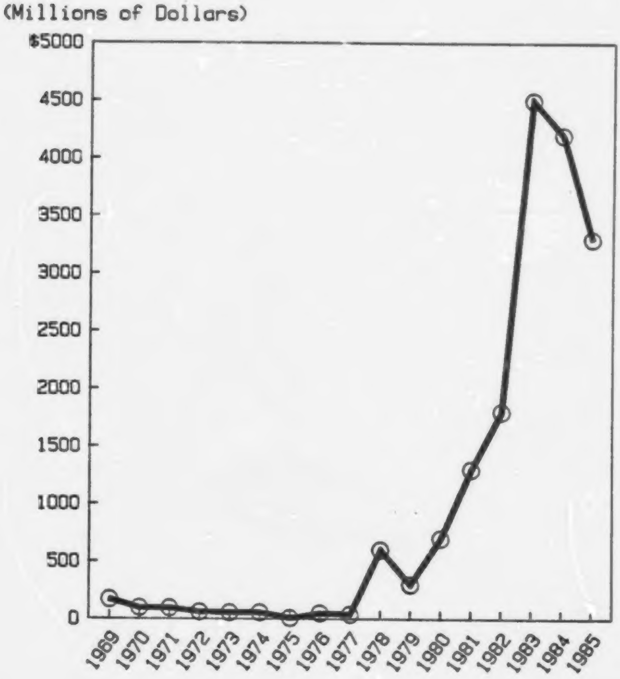
VENTURE CAPITAL INDUSTRY ESTIMATED FUNDINGS AND DISBURSEMENTS (millions)

Year	Net New Private Capital Committed to Venture Capital Firms*	Size of Total Pool	Estimated Disbursements to Portfolio Companies
1985	$3,300	$19,600	$2,600
1984	4,200	16,300	3,000
1983	4,500	12,100	2,800
1982	1,800	7,600	1,800
1981	1,300	5,800	1,400
1980	700	4,500	1,100
1979	300	3,800	1,000
1978	600	3,500	550
Capital Gains Tax Decreased and Differential Reestablished			
1977	39	2,500-3,000	400
1976	50		300
1975	10		250
1974	57		350
1973	56		450
1972	62		425
1971	95		410
1970	97		350
Capital Gains Tax Increased			
1969	171	2,500-3,000	450

*Total new private capital less capital withdrawals.

Source: Venture Economics, Inc.

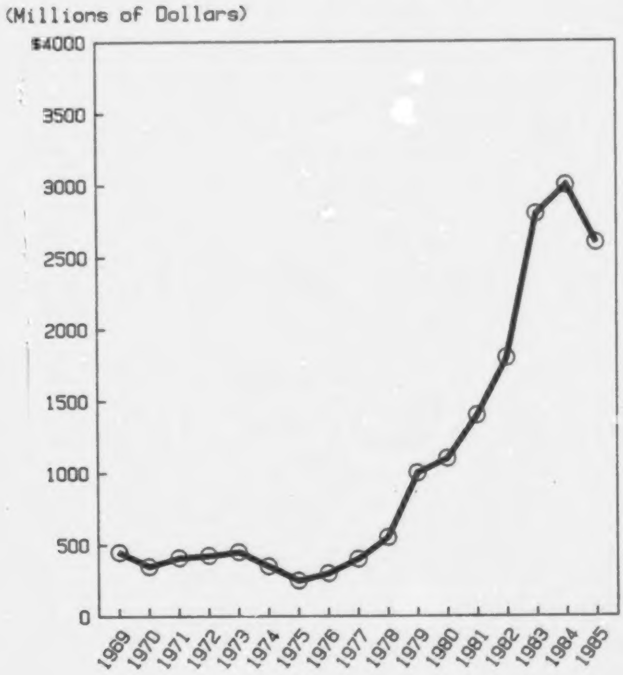
Chart 2
Net New Private Capital
Committed to Venture Capital Firms*



* Total new private capital less capital withdrawals.

Source: Venture Economics, Inc.

Chart 3
Estimated Disbursements to Portfolio Companies



Source: Venture Economics, Inc.

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EXHIBIT 1

ECONOMIC IMPACT AND CAPITALIZATION OF VENTURE CAPITAL-BACKED COMPANIES

Venture Economics, Inc.
16 Laurel Avenue
P.O. Box 348
Wellesley Hills, Massachusetts
(617) 431-8100

June 1986

VENTURE CAPITALISTS FINANCE PROMISING, HIGH GROWTH COMPANIES, MANY OF WHICH BECOME MAJOR CORPORATIONS. EXAMPLES OF COMPANIES FINANCED AND DEVELOPED WITH VENTURE CAPITAL INCLUDE SUCH INDUSTRY LEADERS AS:

- Digital Equipment Corporation
- Data General Corporation
- Intel Corporation
- Prime Computer
- Federal Express Corporation
- Tandem Computer
- Apple Computer
- Lotus Development Corporation
- Compaq Computer

VENTURE ECONOMICS, INC.

THIS STUDY WAS UNDERTAKEN TO SHOW HOW VENTURE-BACKED COMPANIES GROW AND DEVELOP AND HOW THEY CONTRIBUTE TO THE NATION'S ECONOMY:

- Analyzed data on 405 companies founded 1968 to 1980 which received venture capital financing:
  - revenues
  - employment
  - research & development expenditures
  - corporate taxes
  - employee Federal taxes

- Also analyzed data on capitalization for a smaller sample of 92 companies:
  - stock and paid-in capital
  - retained earnings
  - long-term debt

VENTURE ECONOMICS, INC.

THE REVENUES OF THE COMPANIES SHOW RAPID GROWTH:

- By the third year of operation average revenues reached $11.9 million*

- By year six average revenues were $28.5 million. An increase of 139% over year three

- For companies in operation 15 years, average revenues were $139.9 million.

CHART 1 SHOWS THE EXPECTED REVENUE GROWTH FOR 100 VENTURE-BACKED COMPANIES BASED ON THESE AVERAGES.

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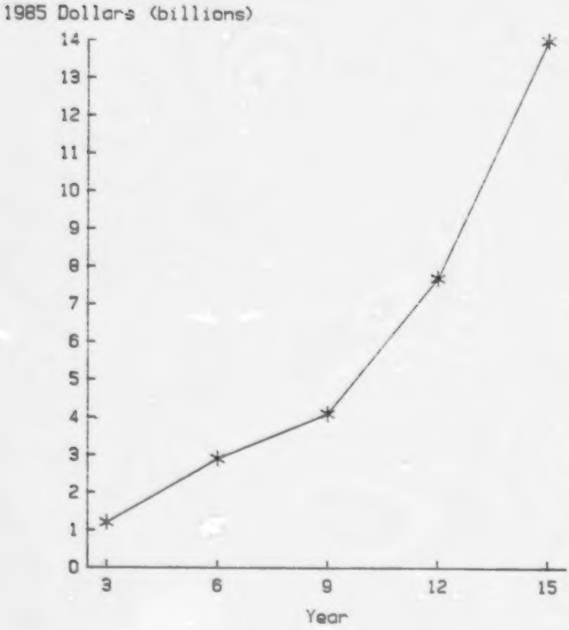
* All dollar amounts have been converted into 1985 dollars to allow consistent comparison.

Chart 1
EXPECTED REVENUE GROWTH for 100 Venture-Backed Companies



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KEEPING PACE WITH THE GROWTH IN REVENUES, EMPLOYMENT IN THESE COMPANIES INCREASED DRAMATICALLY:

- By year three, these companies had an average of 178 U.S. employees

- The average employment increased to 684 by year nine and to 1,808 by year 15

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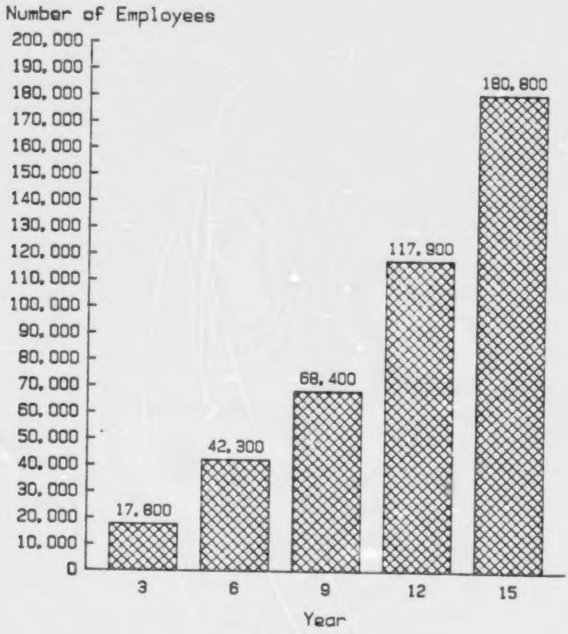
Chart 2
EXPECTED EMPLOYMENT GROWTH for 100 Venture-Backed Companies



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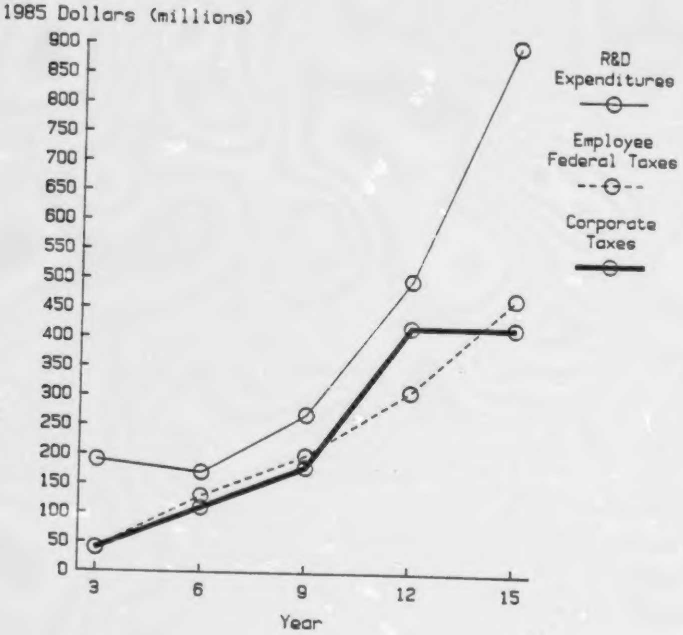
IN ADDITION TO INCREASED EMPLOYMENT, THE GROWTH OF THESE COMPANIES PROVIDED ADDITIONAL ECONOMIC BENEFITS IN THE FORM OF:

- Research & Development expenditures
  - R&D expenditures in year 3 averaged a remarkable 15.5% of revenues during the early stages of development
  - for years 6 to 15, R&D expenditures were sustained at an average level of 6.2% to 6.5% of revenues. This is substantially higher than national averages of 1.5% to 2.0%
- Corporate and employee Federal taxes paid
  - corporate taxes of $420 million by year 12 per 100 companies
  - employee Federal taxes of $310 million by year 12 per 100 companies

Chart 3
OTHER EXPECTED BENEFITS
for 100 Venture-Backed Companies



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TO SEE HOW THESE VENTURE-BACKED COMPANIES FINANCED THEIR RAPID GROWTH, THEIR CAPITALIZATION DATA WAS ALSO ANALYZED:

SOURCES OF CAPITAL*

Average Amount Per Company in 1985 dollars
(Millions)

Aggregate Amount Through:	Stock and Paid-in Capital	Retained Earnings	Long-Term Debt
Year 3	$ 6.9	$ (.7)	$ 1.7
Year 6	19.1	6.2	13.0
Year 9	19.8	10.4	14.4
Year 12	21.9	27.0	14.2
Year 15	37.9	28.6	18.1

* Based on a sample of 92 companies.

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AS THE DATA FOR YEAR THREE SHOWS, IN THE EARLY DEVELOPMENT YEARS THESE COMPANIES:

- Do not have retained earnings to support their growth
- Do not have access to sufficient long-term debt financing
- Are dependent upon equity risk capital to finance their development

x.

BY YEAR SIX, COMPANIES HAVE SOME RETAINED EARNINGS AND ACCESS TO DEBT FINANCING BUT THEY STILL NEED SUBSTANTIAL INFUSIONS OF EQUITY CAPITAL.

- This is the point at which many companies Go public to raise additional capital.

AS COMPANIES MATURE, THEY ARE THEN ABLE TO SUPPORT THEIR GROWTH WITH RETAINED EARNINGS.

- A decrease in corporate tax rates would be helpful for these mature, established companies but the increase in capital gains tax rates and the elimination of the capital gains tax differential would severely disadvantage the young, developing companies which are dependent upon outside sources of risk capital to finance their growth

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APPENDIX

ECONOMIC IMPACT OF VENTURE CAPITAL-BACKED COMPANIES

Amounts in 1985 Dollars
(millions)

	Sample* Size	Number of Employees		Revenues		Corporate Taxes		R&D Expenditures		Estimated** Employee Fed. Taxes
		Aggreg.	Avg.	Aggreg.	Avg.	Aggreg.	Avg.	Aggreg.	Avg.	Average
Year 3	209	37,238	178	$2,497.1	$11.9	$ 75.3	$0.4	$393.5	$1.9	$ .5
Year 6	175	74,062	423	4,990.6	28.5	226.8	1.3	304.3	1.7	1.1
Year 9	154	105,350	684	6,357.8	41.3	312.0	2.0	419.6	2.7	1.8
Year 12	128	150,929	1,179	9,891.6	77.3	535.3	4.2	636.9	5.0	3.1
Year 15	71	128,391	1,808	9,933.8	139.9	300.8	4.[illegible]	642.1	9.0	4.7

ata not available on each year for each company so sample sizes vary by year.

** Employee Federal tax estimates are based on a median ratio of $2,800 in employee Federal taxes/employee for the sub sample of companies for which employee tax data was known.

VENTURE ECONOMICS, INC.

The CHAIRMAN. Mr. Stults.

STATEMENT OF WALTER B. STULTS, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, WASHINGTON, DC

Mr. STULTS. Thank you, Mr. Chairman. I will submit the whole statement. Several observations. NASBIC protests the elimination of the individual capital gains differential in the Senate Finance Committee bill; 90 percent of our industry is in corporate form. The Packwood Finance Committee bill retains a differential for corporations.

Nonetheless I think that I must stress, as other witnesses have, that no matter how big the differential for corporate SBIC's, there is no way they can get a return if there is no demand for the dollars they hold.

Burt and Stan both said that there is a supply of entrepreneurs who will go out and start businesses; they can get in on the psychic rewards. But for the managers who have to be lured away from the major corporations where they have high salaries and good perks to a risk environment with lower salaries and perhaps no perks, the incentive stock option is absolutely essential, and it is the way that our entrepreneurs can staff up. Without capital gains for individuals, the ISO is obviously meaningless.

Let me also point out that the House committee eliminated the differential for corporations; the Senate committee eliminated the differential for individuals. The nightmare for a venture capitalist is when Chairman Rostenkowski and Chairman Packwood get into that conference, how easily will they trade off the worst feature of each of the bills and come up with absolutely no differential?

Finally, let me say that this committee not only held hearings early in 1978 on the Steiger proposal, but it also in the late 1970's heard from dozens of successful American businessmen who founded successful businesses who could get no more rounds of venture capital financing in 1973, 1974, 1975, 1976. They sold out to the Japanese. Congressman Ed Zschau's firm, Systems, Inc., sold one-third of itself to a Japanese investor because there was no pool of venture capital in this country.

Amdahl Computer is another example. This committee took testimony and has it in its archives the names of some dozen of our best, the most successful high-technology innovative firms that went to the Japanese. The Japanese have saved like hell. They have low cost of capital for business.

The Senate finance bill and H.R. 3838 as passed by the House, both are going to increase the cost of capital to the new, the small, the growth business. I believe this is 180 degrees from the direction that public policy should go.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Stults follows:]

NASBIC
NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
1156 15TH STREET, NW • SUITE 1101 • TELEPHONE (202) 833-8230
WASHINGTON, DC 20005

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MARTIN S. ORLAND
[illegible]
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DALLAS TX
*EXECUTIVE COMMITTEE

June 4, 1986

STATEMENT OF

WALTER B. STULTS

Before the

SENATE SMALL BUSINESS COMMITTEE

RE: SENATE FINANCE COMMITTEE TAX BILL

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am Walter B. Stults, President of the National Association of Small Business Investment Companies (NASBIC) which represents the overwhelming majority of all licensed small business investment companies (SBICs) and minority enterprise SBICs (MESBICs). Thank you for giving our Association this opportunity to express its views on the tax reform proposal which has been reported favorably by the Senate Finance Committee.

In common with almost every other business group, NASBIC applauds the results of the Committee's efforts. Its bill represents a major step forward in the campaign to reform the Internal Revenue Code and the lowered top tax rates for both individuals and corporations are commendable.

On the other hand, our Association must express two reservations about the Finance panel's bill: (1) removal of the rate differential on long-term capital gains for individual taxpayers and (2) the increased tax burden placed on business.

CAPITAL GAINS TAXES

Even though the overwhelming majority of all small business investment companies are incorporated and would retain a limited tax rate differential under the Finance Committee measure, about 10% operate as limited partnerships, so their owners will be directly, and adversely, impacted by the bill.

More important than the direct tax increase on the unincorporated SBICs, however, is the threat to entrepreneurial activity posed by the legislation. For the past eight years, the tax laws have given a strong incentive for risk-taking, both by those seeking to start new businesses and by those who invest in such chancy enterprises. The 1978 capital gains tax reduction initiated by Congressman Bill Steiger has rightly been credited for the remarkable spurt in new business formations, for the birth and growth of job creating companies, and for dramatic expansion of venture capital resources.

We believe that the proposed removal of the capital gains tax differential threatens these valuable national economic assets. With significantly lower tax rates on ordinary income and with these higher tax rates on long-term capital gains, we are afraid that risk-taking, both by well-qualified business managers and by investors, will decline substantially. It's probably true that monetary returns are a secondary motivation for those who strike out to form new industries and new businesses. On the other hand, those entrepreneurs must attract good managers if their concerns are to succeed. The lure of incentive stock options and potential capital gains have, for the past eight years, offset both the lower salaries paid by start-ups and the risk that they will fail. What bait can a fledgling company use to attract such people if the Finance Committee bill becomes law?

In addition, I am worried that the end of the differential would make risk investing far less attractive for the ordinary person. Will initial public offerings survive this blow? History proves that IPOs fell off to almost nothing in the 1969-78 period -- the last time capital gains taxes were raised. Will the over-the-counter market retain its vigor if the differential is removed? Again, experience demonstrates that investors shun unlisted issues when the risk-reward ratio is thrown out of kilter by misguided Federal tax policies. Venture capitalists and those who invest in venture capital funds -- whether or not they are taxable -- can show the required rates of return only if a vigorous stock market gives them a way to exit from their successful investments.

The "Cost" of Retaining a Capital Gains Tax Differential

I have attempted to show that the Finance Committee's proposal to remove the differential threatens the vitality of an important segment of the job-creating segment of our economy. If my words have been convincing, you may ask how much will it cost to keep the differential for individual taxpayers.

Mr. Vasquez and Professor Lindsey, witnesses at today's hearing, use sophisticated measurement techniques to answer that question. Without access to computer models, I can only look at the record of Treasury tax receipts over the past 20 years and conclude that lowering the tax rates on long-term capital gains will increase revenues, while raising them has the perverse likelihood of reducing the Treasury's take. From this pragmatic vantage point, I believe the Senate should place the burden of proof on those who argue that a 35% increase in the level of capital gains taxes will bring more dollars into the government pot. I urge the members of this Committee to seek convincing reasons why the projections for post-1986 should be any different from the realities of post-1969 and post-1978.

THE IMPACT ON CAPITAL FORMATION AND BUSINESS GROWTH

As participants in an enterprise which promotes business growth and which depends on capital formation, SBICs have strongly supported public policies which encourage savings and investment. Analyzing the Senate Finance Committee bill from this perspective raises some troubling questions beyond those concerning capital gains tax rates.

In large part, the legislation lowers tax rates for individuals by raising them on corporations. The Finance Committee says that corporate businesses would pay $100 billion more in taxes over the next five years. NASBIC is fearful that the growth potential of many promising businesses will be lessened if the Committee bill becomes law. Let me add, however, that the Senate version is far superior to the House-passed H.R. 3838 on this score, but our concern remains.

Growing businesses are primarily dependent upon retained earnings to finance their expansion; both the House and Senate bills would reduce the ability of such firms to plow their earnings back into the business. I point to several provisions leading me to such a conclusion:

(1) The benefits of graduation end much more quickly than under current law -- that is, firms will pay maximum rates on all taxable income sooner. Indeed, we have the situation where firms earning between $100,000 and $365,000 will pay taxes at a higher rate than corporations earning a billion dollars.

(2) The investment tax credit would be eliminated, thus restricting the ability of smaller firms to invest in new facilities or equipment. To a somewhat lesser degree, the new rules on depreciation would further limit the plow-back option.

CONCLUSION

We hope the backers of the Senate Finance Committee bill are correct when they predict that lower maximum rates on individual and corporate income will spur savings and investment. If they are wrong in this fundamental assessment, the "economic growth" factor in the tax reform trilogy would turn out to be terribly negative. Today's high cost of capital for American business, large or small, relative to that paid by their international competitors, places us at a serious disadvantage. If that spread widens, we shall pay a high price indeed for the good provisions in the Finance Committee bill.

NASBIC urges the members of the Small Business Committee to seek the answer to this crucial question during the forthcoming debate on the tax bill.

Thank you.

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The CHAIRMAN. Walter, thank you very much.

I agree with the comments made and certainly find interesting the statistics given. In the past couple of years, I have noted with some dismay all the shifting around of massive amounts of money in the takeover and merger business of all the old corporations in the United States, and I do not really know what the public gets out of that. Certainly we do not get innovation, we do not get new employment, we do not get any of these things. The Nation should know that whether you are talking employment, whether you are talking innovation, whether you are talking percentage of gross national product, whether you are talking about trade balances, et cetera, were it not for the small emerging businesses we would be in pretty sorry shape.

When I take a look at the statistics, when I take a look at the activity out there in the marketplace, I certainly think this would be an unwise time to take away any incentives to continue those small new growing companies coming into being.

We are fortunate to have—and I think it is testimony to the subject matter and to the witnesses—a great number of my colleagues here at the hearing today. I have no further questions of this panel. Why do we not alternate between both sides and hopefully the Senators will limit their questions to 5 minutes each, at least on the first round, because we do have three more panels coming on top of this one.

Senator Levin.

STATEMENT OF HON. CARL LEVIN, A U.S. SENATOR FROM THE STATE OF MICHIGAN

Senator LEVIN. Mr. Chairman, first let me commend you for scheduling this hearing. I am not sure we are going to have too many hearings on this tax bill anywhere. And I am deeply troubled by a bill coming to the floor this complicated with these kind of ramifications with so many unanswered questions and so little ability for the public to comment.

I have asked a number of questions of the Joint Taxation Committee, asked a number of comments in terms of the impact of this bill. I know a lot of our colleagues have also. I am not alone in that, obviously. Whether we get the information we need even to debate this bill intelligently before the debate ends is up in the air.

So, Mr. Chairman, you are performing a noble service in this environment by even gathering us together so we can hear some testimony on the impact of one provision. There is only about 2,000 pages of provisions in this bill. My reaction is the same as the Chair's. I think that we are going to have a negative effect on capital venture formation in the direction in which we are going, and I am very much concerned about that.

Your statistics are helpful. I think it would be very helpful if you could add to those statistics some information about what percentage of the venture capital comes from the taxable and the nontaxable. You gave us some testimony on that today, but I think if you could give us it in table form, it would be very helpful.

If you could break down that into the seed money issue, which one of you testified to, you said that even a larger percentage of the seed money which seems to be the most venturesome of all the venture capital comes from the taxable entities, as I understood your testimony—I think it was Mr. Pratt's testimony, but I am not sure whose it was. Anything you can give us on that issue would also be extremely valuable to me and I am sure to all of us. And perhaps you could submit that for the record.

Mr. McMurtry. Yes, sir, I certainly will. I will give a chart on that.

[The information follows:]

Estimated Sources of Equity Capital for Private Companies

	Estimated Annual Funding	
	Total	From Taxable Sources
Professional venture capital firms	$2.6 Billion[1]	$1.2 Billion[2]
SBIC's[3]	.4	.4
"Angels" and informal venture capital[4]	5.0	5.0
	8.0	6.6

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[1] Venture Capital Journal, May, 1986

[2] Estimated based upon historical sources of funding

[3] U.S. Small Busines Administration, Investment Division

[4] Informal Risk Capital — Known and Unknowns, William E. Wetzel, Jr., University of New Hampshire, February, 1985

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Mr. PRATT. Let me add one other comment.

When you bring out the seed money segment of it, many people believe that the informal capital pool is approximately the same as the formal capital pool. My $19 billion in the formal venture capital pool invested last year about $2.6 billion. Many people believe that the friends, relatives, of the informal pool, entrepreneurs backing other entrepreneurs, is approximately the same size as the formal pool. All of that is individuals taxable; pretty much all of it is. So, in fact, taxable really dominate the process of startup.

Senator LEVIN. The reason that more information would be very helpful on this subject is that the argument we get for doing what we are doing is that 60 percent or more of the venture capital come from the folks who are not paying taxes anyway. So anything on that subject you could supply us would be helpful, I am sure, to all of us.

One question of each of you. I think at least two of you represent associations, and forgive me for not knowing whether all three of you represent associations, but I know at least two of you do. Do your associations oppose this bill if this provision eliminating the differential remains in it or do you only oppose the provision eliminating the differential?

Mr. MCMURTRY. The National Venture Capital Association which I represent, does not oppose the bill. We strongly oppose the elimination of the differential and have some hope and confidence that that will be restored and that the bill will pass and be a very constructive one.

Senator LEVIN. If your confidence is misplaced and your hopes are dashed to the ground, which once in a while happens, would you support the bill, in that event?

Mr. MCMURTRY. Being a risktaker and an entrepreneur of sorts, I am unwilling to accept the assumption. I do believe that the current Senate bill has many very positive features compared to current law.

Senator LEVIN. See, one of the problems, frankly, with making changes in this bill is that we cannot get folks to say if that provision or the other provision or some other provision stays in it, I think the bill is unbalanced and is a mistake.

There are very few people who will say that, even though I think there may be a lot of people who tend to feel that way. Everybody says, no, we are just going to assume that the right thing is going to be done here. Now I will let you duck because I only have 30 more seconds.

Mr. Stults.

Mr. STULTS. I pass, Mr. Levin.

Senator LEVIN. You want to duck, also?

Mr. STULTS. Our association has not taken any vote on the Senate Finance bill. Obviously—15, 27, 33 sounds good but my members are almost in as bad a shape as Members of the U.S. Senate. None of us have gotten the 2,000 pages. None of us are really certain what is in that son of a gun.

Senator LEVIN. If you find out and if you do take a position on the bill itself, assuming it retains the provisions which you object to, would you let us know what that position is at that point?

Mr. STULTS. I certainly will.

Senator LEVIN. In those events?

Mr. STULTS. We will certainly do that, Senator Levin.

The CHAIRMAN. I will tell you. You are not joking when you say what you are saying and my colleagues say as to their lack of knowledge of what is in the bill. I heard a fascinating report on CBS this morning which linked certain retained exemptions to the various Senators on the committee. That was an eye opener, I will tell you. You all ought to get a copy of that transcript. [Laughter.]

Senator LEVIN. On that point, we have asked for a list of the transition rules. That is the same point, which I think that the chairman is making. Those transition rules for various companies, which by the way may be appropriate, who knows—are scattered throughout 2,000 pages of the bill, apparently.

I would like to see what those transition rules are and what are the common denominators, because it just is possible that 30 other States have similar corporations that meet those standards. It is just conceivable; it is not just 20 States that have such situations and that they exist in other places and they ought to be applied in other situations, or not applied at all; at least we ought to analyze the situation.

My time is up, I think.

Mr. STULTS. May I make just one observation, Mr. Chairman, to Senator Levin?

The CHAIRMAN. Certainly.

Mr. STULTS. We will certainly give you information on the taxable status of those who invest in venture capital partnerships and in SBIC's. I would urge you, however, to think that no matter whether the dollars are put in by a taxable or nontaxable entity, they will get a return only if there is a way to exit. You have a bunch of new venture capital companies in Michigan after all these years. It has finally come to your State. None of them would have put in a single dollar if they did not think that our winners would be able to go public and that there would be a good OTC market.

Now I do not believe that anyone who is pushing for the elimination of capital gains taxes would be willing to predict that the IPO market and the OTC market will not be adversely impacted by the end of the differential. Why not invest in AT&T and take your 6-percent dividend and a little bit of growth, instead of going to some small risky investment that may go completely belly up in the next year?

So it does not matter where the dollars come from. It is how the venture capital community makes a buck. And the pension funds will not put another dollar in Burt McMurtry's firm unless he can take his successful companies public and get a return on investment.

Senator LEVIN. Thank you, Mr. Chairman.

The CHAIRMAN. All right, gentlemen. We will proceed on questioning.

Senator Nickles.

Senator NICKLES. I do not have any questions. I will take just a second of the panel's time just to thank you for having this hearing. I have conflicts like most people do. I know our colleague, Senator Tsongas just left and I wanted to say hi to him. But we appreciate our panelists comments and appreciate your having the hearing.

The **Chairman**. Thank you very much.

Senator Kasten.

STATEMENT OF HON. BOB KASTEN, A U.S. SENATOR FROM THE STATE OF WINCONSIN

Senator **Kasten**. Mr. Chairman, I first of all commend you for holding these hearings on capital gains differentials, and as the debate begins on the Finance Committee tax bill on the Senate floor today or tomorrow, we are focusing this moment on an issue that, I think, deserves our attention and I believe is important to the overall economy, as Mr. Stults just said.

I am not sure what amendments are going to come up on the Senate floor regarding capital gains, but I am deeply concerned over the long-term capital investments and the treatment of capital gains and particularly the effect that the elimination of capital gains deductions would have on such amendments.

Being a Congressman from Wisconsin at the time that Senator Bill Steiger was beginning his battle in the middle 1970's on capital gains, and I think that was also the beginning of the overall debate that we have on growth economics today—I mean the basic idea that you can cut the rates and see the revenues be maintained or see the revenues be increased—I think that we are very much talking about the same clash in terms of the battle of ideas that a number of us have been fighting in different ways, and to think that we were successful in now cutting the rate on unearned income from 70 to 50 percent and still seeing total dollars growing in 1981 and 1982 from that amount I think that the basic underlying economic premises that we were working for in 1975 and 1976 and 1977 with Bill Steiger are becoming more and more clear.

I would like to ask each of you—and I missed the beginning of your testimony, but I am not sure exactly what you are asking us for today. And may be we could begin.

Mr. McMurtry, my understanding is that at least some groups may not be seeking exact restoration of the current law. My understanding is also that some people are saying that they are absolutely committed to keeping the top effective rate no higher than its present 20-percent level, no matter what happens with that 27 or 28 or Kemp-Kasten 25 whatever percent that you absolutely—then my understanding is also that there are some people that are saying no, we want a differential, but we are not as concerned as we are about the exact dollar amount, and my understanding is that there is another group of people—or maybe it is one of you that are talking about trying to deal with the attack that has been made that capital gains benefit people at the higher income levels are trying to explore ideas of a two-tier capital gains treatment.

What specifically, Mr. McMurtry, are you asking for in the tax bill? Is there an amendment, or if there is not an offer of an amendment, is there a specific remedy that you are asking for?

Mr. **McMurtry**. We are——

Senator **Kasten**. And I would like to go across, if I could, with Mr. Pratt and Mr. Stults.

Mr. McMurtry. Thank you, Senator Kasten.

We are not as specific yet as we would like to be, and we believe we need to interact with the Senate to a fair extent before we can be that explicit. We do feel very strongly that the differential should be maintained at a significant level, and our view on that is that something on the order of a 50-percent differential probably would be very desirable from an overall economic point of view.

We also believe that any increase in the capital gains tax rate from current law at 20 percent would be very disadvantageous. But that is as specific as we are at this stage of the game. Other panelists may be able to be more specific.

Senator Kasten. Can you comment on this debate that I understand is going on within at least part of the capital gains community, in terms of higher income, lower income? I do not happen to buy much of that overall argument, but some do.

Do you understand this two-tier question that has been at least addressed by some?

Mr. McMurtry. I am not close enough to those arguments to comment. I think other panelists may be.

Mr. Pratt. No; I am not really close enough to the two-tier argument on capital gains. I happen to be a great believer in simplicity, and I would prefer to keep it that way.

What I am asking for very strongly is to make sure that we keep the differential, that we reward builders more than traders. I happen to agree with the chairman here that our whole economic economy today is being dominated by traders, people who are just trading one thing for another and not really building anything for the future, that a 50-percent differential will get people to build. That is what I believe. What I want is a differential between the taxation on ordinary income and the taxation on capital gains. I have not heard myself of a two-tier capital gains tax structure.

The Chairman. Is what is being referred to here, in other words, that under the two-tier proposal 15 percent and 27 percent, in other words, that the capital gains would go to the lower tier, the 15 percent?

Senator Kasten. There would be a different treatment of capital gains for lower income investors who invest in capital gains and take advantage of them than there would be for higher income investors, just as we have two tax rates overall.

The Chairman. I see.

Senator Kasten. That has been reported in a number of newspapers. I have talked to at least a couple of small business types from Wisconsin that said this is one of the things that they understood that some here were considering.

Mr. Stults.

Mr. Stults. Senator, we had not been aware of that sort of a proposal. I would only second the two other panelists that the differential is more significant than the actual formula by which you come to that differential. For our industry, I am certain that keeping the personal, the individual at 20 and the corporate at 28 right now, retaining the differential, is the significant symbolism that the Congress can show. The symbolism is terrible if you reduce it and say that investments in high risk situations, long-term investments are no different from the straight trading, speculating and the like.

The **Chairman**. I am going to have to stick to the 5-minute rule because we have three more panels coming up after this, and I would really like to get all the information we can. I will be glad to return, but I want to give every Senator an opportunity.

Senator Bumpers.

Senator **Bumpers**. Have you asked questions yet?

Senator **Sasser**. No.

The **Chairman**. Senator Sasser.

Senator **Bumpers**. He was here before I was. Let me defer to him.

The **Chairman**. Senator Sasser.

STATEMENT OF HON. JAMES R. SASSER, A U.S. SENATOR FROM THE STATE OF TENNESSEE

Senator **Sasser**. Thank you very much, Senator Bumpers.

I want to join in the accolades for the chairman, No. 1, for calling this hearing today. I think it is indicative of the aggressive and perceptive manner in which the chairman has run this committee. The chairman has been very sensitive to the needs of the small business community generally, and I want to express my thanks to him for calling these hearings.

I think these hearings this point up a problem that we have. I want to follow on what Senator Levin said just a moment ago. We are being called upon to pass on a tax bill here of well over 1,500 pages that I dare say not a single Member of the U.S. Senate has read in toto. And the venture capital community is denied access to the Finance Committee to plead their case. So they come here to the Small Business Committee to do it, and I am pleased that we can serve that function.

Having said that, gentlemen, let me just play the devil's advocate here for a moment and get your response. The Venture Capital Journal reports that 33 percent of the funds going to private venture capital funds in 1985 came from pension funds, and of course these are tax exempt. Another 23 percent of the venture capital came from foreign investors. This group is also not affected by the capital gains rate and finally, 8 percent came from tax-exempt foundations. So you have 60 percent of the money going to venture capital firms coming from sources that are unaffected by the capital gains rate.

Now why would venture capital dry up or be adversely affected if we adopt the Finance Committee proposal?

Mr. **Pratt**. Well, first, as publisher of Venture Capital Journal, as I say, those are my numbers.

Senator **Sasser**. That is the question, Mr. Pratt.

Mr. **Pratt**. Those are my numbers of only one segment. In other words, what you are doing is saying let us take half the industry and make a measurement on that and say it represents the whole industry. In fact, the whole industry involves another $5 billion over that one segment which is just the funds. We detail in the journal those numbers for the funds to help the people that are out raising money to point where they ought to be looking for it. But, in fact, a large part of the industry is not these independent private funds.

The independent private funds of the $19 billion are only about $12 billion. I mean it is a significant, almost—it is two-thirds of it, but it is not the whole industry. So I would like if possible to have people stop extrapolating percentages for one segment for the whole industry, which is what the people opposing this plan are doing and they are obviously getting through to people.

What I would like to do is to have you focus on the whole industry, which is $19 billion. Of that, 65 percent comes from taxable sources in the United States. That excludes pension funds, endowments, and all foreign investments. The fastest-growing segment in our sources today happen to be foreign people, interestingly enough.

Senator SASSER. Foreign investors?

Mr. PRATT. Foreign investors.

Mr. MCMURTRY. I think it's incumbent upon us to provide more clear information to the Senate about the sources of venture capital, and as we discussed a little earlier, and I will mention only briefly, a great deal of the seed capital—that is, the capital that goes into the very earliest stages of starting a business—a great deal of that capital comes from individuals, individual investors, and small seed funds, whose partners are largely individuals.

That part of the process is very significantly dependent upon tax rates and the differential. If that part of the process is throttled, then we think the consequences for the rest of the process are in trouble, as well. But it is an important question.

Senator SASSER. Gentlemen, Martin Feldstein has argued that taxing capital gains at the same rate as ordinary income is a bad idea, partly because such a proposal would actually lose revenue. Do you agree with his assessment that the Finance Committee provision on capital gains would actually cause the Government to lose revenue or do you have an opinion on that?

Mr. MCMURTRY. I personally think it would cause a loss in revenue, although we have a witness who will testify in a few minutes who has done some calculations that I think you will be interested in that indicate that there may be a slight gain.

Senator SASSER. Thank you, gentlemen.

The CHAIRMAN. Thank you very much, Senator Sasser. Thank you for your kind remarks.

Senator Gorton.

STATEMENT OF HON. SLADE GORTON, A U.S. SENATOR FROM THE STATE OF WASHINGTON

Senator GORTON. Thank you, Mr. Chairman.

Senator Kasten mentioned his experience in Congress while Congressman Steiger was making the first great reduction in capital gains taxes. If my memory serves me correctly, capital gains taxes were reduced in 1978 to 28 percent. That resulted not only in the taking of many gains, but I gather in a great deal of additional investment of the kind you advocate. This proposal would raise the capital gains rate to 27 percent, 1 percent less than Congressman Steiger reduced it to. Why is it such a disaster?

Mr. MCMURTRY. I think that's a very good question. I think the reduction in 1978 produced the results that you describe. The further reduction in 1981, the 20 percent, I believe, is also producing very substantial positive results, and I do not think we have exhausted the positive results that we can achieve through lowering capital gains taxes.

I also believe that the signal that we send, if we increase the capital gains tax rate by 35 percent or more as is being discussed, is just the wrong kind of signal to be sending to entrepreneurs and to investors.

Mr. STULTS. Senator Gorton, if I could jump in there. The rate was 70 percent on investment income. If you have got interest or dividends, you paid 70 percent to Uncle Sam. Capital gains was 28 percent.

Senator GORTON. I see. I see. It's more of the differential than the actual rates.

Mr. STULTS. Yes, sir.

Senator GORTON. What you're telling us is that from your perspective a tax system with a 70-percent marginal rate on ordinary income and a 28-percent capital gains rate is better than 27 percent for both?

Mr. MCMURTRY. No.

Mr. STULTS. Absolutely not.

Mr. MCMURTRY. I think there is tremendous advantage to the whole economy in lower overall rates. Absolutely.

Mr. STULTS. The differential—I am sorry—is what I was excited about, not the lower rates.

Mr. PRATT. I think we all agree that the differential is the really key point in motivating the entrepreneurs and attracting the managers that we really need for the process.

Senator GORTON. So if we have a 10-percent ordinary income tax rate, we damn well better have a 5-percent capital gains rate?

Mr. PRATT. At some point you become inefficient when you are moving these things, as the economists will tell you. I am not sure. I would say that anytime you can have a reward for long-term investment, you should have it.

Senator GORTON. One of you—and I am sorry I forgot which—in answer to a previous question, used the analogy of the trader versus the builder. Is it not true that capitals gains, even in the form of equity stock, go about somewhere between 95 and 99 percent to traders and 1 to 5 percent to builders? You are talking about investments in your high technology risky industries. But the great bulk of the capital gains benefit goes to people who are buying IBM stock and then selling IBM stock after 6 months, is it not?

As a matter of fact, the staff memo we have here uses that as an illustration: IBM. That is just a trader, is it not?

Mr. PRATT. Not necessarily. I have been in venture capital for years. My largest holding happens to be some IBM stock that my father bought in 1928. Now he was not a trader and I am not a trader. We happened to hold on to our IBM stock.

Senator GORTON. You haven't sold it?

Mr. PRATT. I am rich because of that.

The fact is, yes, that people trading stocks do get some benefit from it. But I think that that ties in with the point that Walter brings out, that stock markets are an important stimulus to the realization process. Venture capital is no good, if we do not give a return to the investors. We need to have orderly stock markets in order to do it.

I opposed the reduction of the holding period personally because I happen to believe that I like to see long-term holders rewarded. What I would really like to see is the long-term rates say at 1 year as they are going down, half of that after 3 years, and zero capital gains tax at the end of 5 years.

Senator GORTON. But what you are telling me conceptually is that in order to get the 5 percent of investment, which is in new corporations true venture capital, you have to give this special differential treatment to the other 95 percent who are buying existing stock?

Mr. PRATT. No; I——

Mr. MCMURTRY. I would say that that is probably true because you indeed need vibrant equity markets, and I think there is some in fact, there is investing done in the equity markets in addition to just trading, and I think that one needs to be willing to provide incentives at that level, also.

Senator GORTON. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. The point has been made that possibly there is an amendment which responds to the question of the Senator from Washington, the lower capital gains rates to newly formed corporations.

Senator GORTON. I have heard that suggestion.

The CHAIRMAN. Which then obviates the situation of trading in old stocks, if you will. I am not saying that will meet your approval, but it very well might be one of the avenues, for the reasons stated, which enjoy some success on the floor.

Senator Bumpers.

STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM THE STATE OF ARKANSAS

Senator BUMPERS. Mr. Pratt, I certainly agree with you on the 6-month holding period. And I was able to hold the Senate at bay for over a year in reducing that rate because of the reasons that Senator Gorton mentioned.

But be that as it may, there are two incentives behind capital gains rates. I studied the history of capital gains at length during that long and lonely and losing battle back in—I do not know when it was; about 1981—but there are two reasons for the capital gains tax.

One is to protect people against inflation; and No. 2 is to encourage people to take a risk, venture capital. If you study the history of capital gains, when I came here the holding period was 1 year and the rate was 49 percent. Then we reduced the rate to 28 percent. Then we reduced the holding period to 6 months. Then we reduced the rate to 20 percent. And it has just been a constant erosion of that.

But, of course, when the rate was 48 or 49 percent, the marginal rate was 70, which, incidentally, is what we should have done in 1981—and if you read David Stockman's book, he would pretty much agree with that; I hated to read it because I knew he was lying at the time—but he points out in that that the marginal rate was the thing they were really after.

Well, having said all of those things, Senator Mitchell is going to offer an amendment to raise the rate to 35 percent on personal income. Now you can look amazed when I say that, but I think we have all been trapped into believing that there is something sacred about 27 percent, and I am not sure that I am going to vote for his amendment, but let us assume that he prevails. Would a differential of 35 to 27 percent make any difference? Or should the differential be 20 to 35 percent with an extension of the holding period for a minimum of 1 year?

I will tell you what I personally favor. I personally favor no tax at all in investments that are held for an extended time, for example, for 3 years. And I would favor a very low rate for investments held for 2 years. And I would scale it based on the holding period.

While I am at it—and I am not really asking a question: I am preaching a sermon here—but there is another thing that really troubles me. That is if you take away the capital gains rate totally, I really worry about the kind of volatility that is going to occur in the marketplace and on Wall Street where people buy 1 day and sell 3 days later, whereas you know they would otherwise hold for 6 months.

I think you are going to see the volume on the New York Stock Exchange skyrocket once this thing goes into effect. But that is a separate question, the volatility of the stock exchange. But if we have a 35 percent rate, is a 27 percent margin enough differential?

Mr. McMurtry. My reaction is that a 35 percent maximum ordinary rate and a 27 capital gains rate, since there would be a differential, is clearly advantageous compared to a 35-percent rate for both with no differential. But I believe it still would be a step in the wrong direction. I think the differential should be 35 versus 20 or 35 versus 17½.

Senator Bumpers. How long a holding period would you be willing to accept in exchange for that?

Mr. McMurtry. Boy, that is a tough question because in a provincial sense, as a venture/investor, you can argue for very long holding periods and you, in fact, are stuck with long holding periods. Whether you like them or not, you have just got them.

But it is so important to the whole economic process of growth companies and into the venture process that there be vibrant equity markets and to the extent longer holding periods might inhibit capital flows in equity markets and might weaken the markets, then I think they would be disadvantageous. So I think it is a very tough issue.

Senator Bumpers. If all else fails, how would you feel about scaling the rate back—well, no. If all else fails, what about a fall-back position of a capital gains rate, that is, an advantageous differential and capital gains rate for startup venture capital only?

Mr. McMurtry. That is also tough. I think that would be unfortunate because some of the—and in Stan's report, with this latest information on companies and 405 companies started between 1968 and 1980—if you look at the capital that flowed into those companies, they raised a fair amount of capital in their earlier stages and then the amount of capital they raised from year 3 to year 6 was twice the amount of capital they raised in the first 3 years. And that additional capital generally came from the public markets.

We might have a lot of things getting started, but we would not have the liquidity; we would not be able to permit the financing of the growth of the businesses unless we have really vibrant equity markets for publicly traded securities. So I would be disappointed if that turned out to be our only result.

Senator **Bumpers**. In 1984—Walter, either, do either you or Mr. Pratt want to add anything to what he said on those points?

Mr. **Pratt**. Not really. I very much really agree. As everybody knows, I am one that would be willing to go a year, as we can do, in order to get this back, again. Our equity markets did not fall apart when we were at one year. But I believe you do have to balance both.

I am generally against targeted tax measures for one group or another because I feel then the other guy is going to start beating on you the day you get it. So I would rather not target, but I will take half a loaf rather than no loaf any day.

Senator **Bumpers**. Well the biggest risks of course are in startup capital, I mean in new corporations and so on. The SEC did a study in 1984 that shows that $334 billion was available to firms from retained earnings and depreciation as opposed to $147 or $148 billion from external sources.

In short, corporations depend on retained earnings more than they do on outside capital. And so since you have to have probably $500,000 in income to issue a public offering and only 1 percent of the firms in the country qualify, I was just thinking that this rate for people who are starting for the first time—I am not suggesting that as a panacea, but as a fall-back position—and why would that not be beneficial to venture capitalists such as you?

Mr. **McMurtry**. It would clearly be beneficial to venture capitalists such as us for early stage investing, but it may not be net beneficial if the markets for additional capital for these growth companies are really not as vibrant as they might need to be.

Mr. **Pratt**. On page IX of my study, you will see this chart which shows that in the earlier years, these companies must get their capital from paid in stock and paid in capital. But in the later years of these rapidly growing companies, you rely on both the capital and the retained earnings. You, in the next panel, will see this perspective from two groups—one, startup-oriented and the other major growth company, continuing to grow after having achieved a certain size. So it is very important you see both aspects of this, I think.

Senator **Bumpers**. Thank you, Mr. Chairman.

The **Chairman**. I thank the members of the panel very much for taking time to be with us and giving us their knowledge. Thank you so much.

Our next panel consists of Jack Lloyd, president, Nellcor Inc., Hayward, CA; and Dr. George Hatsopoulos, president of Thermo Electron Corp., Waltham, MA.

Mr. Lloyd, it is a pleasure. Why don't you proceed.

STATEMENT OF JACK LLOYD, PRESIDENT, NELLCOR INC., HAYWARD, CA

Mr. Lloyd. Thank you, Mr. Chairman. I am an entrepreneur, and I have personally started three new high-technohogy companies in the last 15 years. I have been fortunate in that these companies have been successful. They have all made profit; they have all paid taxes; and, in fact, the shareholders have all made money. They have produced about a 1,000 jobs in the San Francisco Bay area in the last 10 years.

The company I started in 1974 made instruments for eye doctors, and it now employs about 500 people. It does about $50 million of business and is operated by a large pharmaceutical company.

I started my present company 4½ years ago. It employs 465 people. It makes medical instruments that reduce anesthetic accidents in surgery and the associated costs of medical malpractice claims. In our second full year of sales which ends this month, we will do about $45 million in business. I expect that the next fiscal year we will pay about $8 million in Federal and State taxes directly.

I would like to make some remarks on what it takes to start a high-technology company. First, you have to be able to raise capital. I think the point that has to be understood is that technology moves very rapidly and if you are to compete, particularly against foreign competition, you have to raise that capital from outside the company; profits are not sufficient.

These investments are very risky, and if you want the company to grow to something large, you have to work in an area where it is not a me-too business, where you are doing something new and different.

The seed money it takes to start a company like this, in my experience, does not come very often from the classic venture capital sources—this kind of startup is just too risky for them—it comes from founders and it comes from the people who believe in the founders—usually individuals—usually people of some means. In fact, the first million dollars or so that I raised for my present company, Nellcor, was raised from these personal sources. The venture capital came in later when we had management in place and instrument prototypes in the field.

I think to encourage people to make these risky investments, there has to be a differential between what they would normally get in an investment and what they would get from a long-term commitment to investing in a company like mine. They take the chance of losing all their money and they lose the access of their money for some long period of time—3 to 5 years, perhaps. And I think that if they don't have a differential, they will put their money in municipal bonds or tax shelters or real estate—things which will not help grow companies.

I think that we have to preserve some kind of differential or we will not be able to raise money for companies like mine.

I think the other issue, which is very important in this area, is the people resources you need to start a company. You cannot start a company just with entrepreneurs. You need management, you need marketing, and you need scientists and engineers. These people can get good, well-paying, safe jobs in the industry. We need tools to attract them away from big companies where they are safe into places where they can help the entrepreneurs build companies.

I think the intellectual challenge for them of building a company is not enough. They really need a carrot to get them to take on the uncertainties and the risk and the hard work and time away from their families. I think that along with the capital gains differential for equity investment, there also needs to be a continuing program to support incentive stock options to be able to attract these people because they are the ones that make the companies go.

I think the choice has to be made by the Congress. Does it want the country to build high-technology startups; does it want the entrepreneurs to succeed? If it does, then they have to provide the tools that we need to build these companies.

Thank you.

The CHAIRMAN. Thank you, Mr. Lloyd.

[The prepared statement of Mr. Lloyd follows:]

STATEMENT OF JACK LLOYD, PRESIDENT, NELLCOR INC.

Mr. Chairman and Members of this Distinguished Committee:

My name is Jack Lloyd. I am an entrepreneur and I have personally started three new high technology companies. These businesses have produced more than 1000 jobs in the San Francisco Bay Area in the past ten years. They are profitable and they pay taxes.

BACKGROUND

I hold an engineering degree from the University of California at Berkeley and for 10 years worked as an engineer and engineering manager at the then University of California Radiation Laboratory, designing instrumentation for physics research under AEC and NASA contracts. My present career as an entrepreneur began in 1970.

EXPERIENCE IN STARTUP COMPANIES

I have been very fortunate. Each of the companies I started was successful. Each of them made a profit, paid taxes, and hired a lot of people. The shareholders have all made money on their investments. My first company manufactured peripheral equipment for the mini-computer market. In 1974 I founded a company that made a new type of instrument for eye doctors. That company now employs more than 500, profitably sells about $50,000,000 per year and is operated by a large pharmaceutical company.

NELLCOR INCORPORATED

My present company, Nellcor Incorporated, was started five years ago and now employs 465. It makes medical instruments that are saving lives by dramatically reducing anesthetic accidents during surgery and the associated costs of medical malpractice claims. In this fiscal year, our second full year of sales, Nellcor will sell over $40,000,000 of product. I expect that Nellcor will directly pay $8,000,000 in Federal and State taxes in its 1987 fiscal year.

WHAT IS REQUIRED TO START A HIGH TECH COMPANY

I think only a few have experienced the thrill and satisfaction of gathering together a few very bright, very well trained people, thinking up a new product idea, renting a big empty building and spending the next years building a company based on new technologies and new products. This is a peculiarly American phenomenon. But to be successful two things are essential.

CAPITAL RESOURCES

First, you must be able to raise capital. Technology moves quickly, and if your company is to compete, especially against foreign competition, you must be able to move equally fast. This means capital must be obtained from outside the business, not just from profits. These investments are necessarily risky, because if the enterprise is to grow to something big, it can't be just a me-too business, it's got to be something new and different.

The seed money, from my experience, often doesn't come from venture capitalists. Many of these ventures are too risky even for them. It comes from founders who believe in their ideas and abilities and from private individuals who believe in the founders. In fact, the first million or so dollars used to start Nellcor was from these personal sources. The venture capital we used came later when we had product prototypes completed and a management team in place.

To make these risky investments, investors need a real incentive. If they don't have it they will choose safer investments. Because I have spent many, many hours in front of potential investors, convincing them to put their money in my companies, I think I understand their thoughts as well as most. Because of the higher risks, they need to feel that there is an extra economic advantage in it for them, for they will only profit if the business is successful. If they don't have this advantage they will put their money into real estate and municipal bonds.

MUST HAVE CAPITAL GAIN INCENTIVES

This nation will be best served if the tax code preserves the differential for long term capital investment. New high tech startups must have it. We don't need R&D tax shelters or fast depreciation. We need the incentives to encourage investors to take the risks that let us turn ideas and hard work into : al businesses that make jobs, pay taxes, improve the quality of life in America and let us compete abroad.

PEOPLE RESOURCES

The second point I would like to make is that it is essential to the success of these high tech companies that well trained and motivated technical, marketing and support people be recruited. Without them nothing can happen. They are in high demand by every segment of business. The best people can always get the best and highest paying jobs in the safety of big companies. We need the incentives to compete with these organizations. We can't pay large salaries in the formative years of a new venture. We demand very hard work, long hours, and full commitment from our professionals. The intellectual challenge of using their skills to build something new and important is essential, but it is not enough. There must be a financial "carrot" out there to offset the hardships, the uncertainties, and the time away from their families. The incentive that has worked so well in the past and which is now in jeopardy is the stock option.

MUST HAVE STOCK OPTIONS

There must be provisions in the tax code that will permit the entrepreneur to attract and keep employees in the formative stages of a new venture. Funds are limited, and it is not possible to attract the right people with salaries only. Options are an opportunity and motivation for key people to participate in the success of the enterprise. If we can't get them, we can't build these companies. They must have tax treatment on their options which are significantly better than on their salary. If they don't, they won't take the risk. These are not tax give-aways to the rich. They a rewards for hard, devoted a continued work in building companies that are not possible through ordinary salary compensation. If this country wants new ventures to start, it must make it possible to get these skilled and talented people to join with the entrepreneurs.

I have had many conversations with my European and Japanese business colleagues about this uniqueness of the American high tech start up. How do you get people to give a million dollars to two guys in an empty building to see if an idea works? How do you convince the best scientists, engineers and marketing people to leave their secure, high paying jobs to join the founders? It remains a mystery to them. I know what it is. It is the highest form of professional challenge for many Americans. At least until now, the government has said by its tax policy that it wants to encourage high tech startups and has given us the tools we need to make it happen.

SUMMARY

Unless the proposed tax legislation includes a substantial differential for long term capital gains, the availability of the essential capital investment necessary to start high technology companies will be severly limited. If stock options are not available in some meaningful form, differentiated from ordinary income, it will be very difficult to attract the human resources that are necessary. I strongly encourage you to consider these issues in your deliberations on the current tax legislation.

Thank you for the opportunity to make these remarks.

The **Chairman**. Dr. Hatsopoulos.

STATEMENT OF DR. GEORGE N. HATSOPOULOS, PRESIDENT, THERMO ELECTRON CORP., WALTHAM, MA

Dr. **Hatsopoulos**. Thank you, Mr. Chairman.

Let me first apologize for not having submitted a written statement. But all this past weekend I have been working all day on an equity offering of our company, and as you may know this takes a lot of time, and I did not have the time to prepare the statement. On the other hand, if the capital rate differential is eliminated, I can assure you I will have more time available because the offerings will not be that frequent.

The whole discussion on the capital gains differential has been centered around startups, and I think that the points made in this committee and in the literature are very well taken. Venture capital, seed money, new startups, entrepreneurship, risk-taking—all depend on the differential.

But there is another aspect that has been overlooked, which I would like to address. That is, that these new startups start benefiting the economy 10 or 15 years later when they become of a size that they can provide a sizable contribution to GNP and employment, and international trade. Companies such as Digital Equipment or ourselves—Digital Equipment happens to be 10 times our size, but companies that are in mid-sized or even of the largest size have provided most of the jobs in the last few years.

We have made studies of these high-growth companies and found certain characteristics of them. One characteristic of all these high-growth companies is that they pay no dividends; they retain most of their earnings.

Another characteristic is that they have easy access to capital markets, even though they are not paying any dividends, which is a very unusual thing. Neither Digital Equipment or ourselves have paid any dividends. Yet we have access to equity markets; in fact, we are making an offering now.

Just to give you a sense of size, over the last 10 years we have been growing at the rate of 25 percent per year, with half the money coming from new equity offerings. Half the money came from retained earnings. I have not looked at the numbers of Digital Equipment, but I would suspect that they would be along these lines.

Now, soon after the discussion of eliminating the capital gains differential came along and the Senate bill was published, I received a call from our investment bankers, Shearson-Lehman, and they said:

> George, I know your long-term objective is to pay no dividends. But if this bill comes to pass, I think that you will have to pay dividends if you want to retain the price of your stock, because people will have no incentive for you to retain the earnings and build up value of the capital. Since there would be no differential between those two taxes, they would prefer to take the money now and then they would make the decision about what they are going to do with it. They may want to buy a yacht with it. They may want to invest somewhere else, or they may want to consume it. And you have to take that into account.

This was a shock to me, Mr. Chairman, and frankly, I think that the major immediate impact, of eliminating the differential is going to be in the growth of the country right now.

Eventually, I think that the effect on new startups will hurt the country in the long run because it is today's new startups that will create the jobs 10 years from now. But the immediate impact of this in the economy is not going to be felt so much in the startups, but will be felt in the growth companies that pay no dividends. They not only have access to equity markets with high P/E ratios, but they also have an opportunity to retain all, if not most, of their earnings.

I would like also to make a point, in conclusion, about who benefits and who gets hurt from the elimination of the differential. For instance, am I here testifying because our investors or stockholders would get hurt? I might say no, Mr. Chairman, no matter what the bill is, I will organize our plans so that our stockholders get the proper returns. It is the country that will get hurt if we have a new bill, and I will have to pay more dividends—I will pay more dividends. There will not be so much growth.

On the other hand, our stockholders will get the same returns. In fact, if you look at the capital gains differential, even if capital gains paid zero tax, there would be no windfall to anybody because the capital markets are mostly efficient and the after-tax return of investors is the same.

In other words, all the Tax Code does is guide investors on where to put their money, whether to put it in a risk situation or to put it in one with immediate returns.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. I think you raised a very interesting point on the matter of retained earnings and dividends. I have no questions.

Senator Boschwitz.

STATEMENT OF HON. RUDY BOSCHWITZ, A U.S. SENATOR FROM THE STATE OF MINNESOTA

Senator BOSCHWITZ [acting chairman]. Mr. Chairman, I know the witness and have spoken with him before. I confess, as you see, that I am a newcomer at this hearing. I believe I take the viewpoint that he does, and that is that capital gains represents a gain on income that has already been taxed and from the standpoint that earned income, what you save and then invest in—invest as capital is income that has not been used for consumption but rather for savings and capital formation.

Historically, we have always taxed capital gains at a different rate and hopefully we will be able to work that out here. It's not clear to me. In the event, if I could ask a question, Dr. Hatsopoulos, and that is that let us presume that the Senate rejects all amendments to this bill. Would you vote for or against the bill on final passage, in that case?

Dr. HATSOPOULOS. This is a very difficult question, Senator.

Senator BOSCHWITZ. One that I will probably have to face.

Dr. HATSOPOULOS. But I have thought about it quite a bit. I would still vote for the bill, because I believe that eventually the detriment of eliminating the capital rates differential is going to be so evident and these hypothetical revenues that presumably will come in from elimination of the differential will so evidently not be there, and also provided that you, Mr. Senator, intend to raise the issue after the bill passes, and have a hearing 1 year from now and say, let us look at what happened to that bill. Did we get any money? Did we hurt growth? Did we force companies that otherwise were growing to now start paying dividends?

If you tell me that you will hold that hearing, then I will vote for the bill.

Senator **Boschwitz**. I will hold the hearing, and not only that. I think that from a plateau of 27 percent, that those kind of things will be more easily fixed, so to speak, than from a plateau of 50 percent.

So I am inclined to take your attitude that I would vote for the bill, in the event that none of these amendments would pass. I am concerned about the impact of retroactivity on investment decisions and I am also interested in the IRA's. Frankly, I think we, as Republicans, are doing it to our own folks. The presence of Senator Tsongas here today maybe indicates that he is among our folks now, on the Republican side. Who knows? I would not have recognized him, anyway.

But let me address the same question to Mr. Lloyd, if I may.

Mr. **Lloyd**. I think you have to consider the effect of eating the seed corn because I think that elimination of a differential will mean——

Senator **Boschwitz**. You have to consider the effect——

Mr. **Lloyd**. The effect of eating your seed corn.

Senator **Boschwitz**. Eating your seed corn.

Mr. **Lloyd**. I think the effect of eliminating the differential means it will be much harder to start new companies from scratch and I think the other benefits of the bill have to be weighed against that situation.

Senator **Boschwitz**. My question to you is, let us presume that the Senate—that Senator Packwood is able to put together his 51 Senators who oppose all amendments, and that he is successful in opposing all amendments. Then we have to rely on good things happening in conference. Good things do not always happen in conference, so that you have to take that into account, too.

Would you vote for or against the bill, in the event it goes through the Senate unamended and now a vote comes down on the Senate floor and says yes or no on the bill in its entirety?

Mr. **Lloyd**. I think there is one very bad characteristic, if that happens. The one I mentioned. I do not understand the bill well enough to be able to weigh the rest of it at this point.

Senator **Boschwitz**. Well, I am sorry that I did not have a chance to question you earlier. in that case, Mr. Lloyd, because if you do not understand the bill well enough, do not talk about one section of it. You have to have a broader understanding of it.

Well, we are going to have the next panel.

Are you——

Dr. **Hatsopoulos**. Senator Boschwitz, I know that you took an interest in the costs of capital work we have done, and there is a study that I would like to submit for the record that explains that part of the differential between the United States and Japan is due to the fact that Japan has zero capital gains.

Senator Boschwitz. I am not informed on capital gains rates in the European and the other industrial nations. I know that in Korea and in Japan, it is nothing. I have no idea what it is in Hong Kong or Singapore, but I presume it is very low.

Dr. Hatsopoulos. I do not know that. But Japan and Germany, I know, have zero.

Senator Boschwitz. England, France, and Italy and——

Dr. Hatsopoulos. Sweden, which is a socialistic country, by the way, has zero, but has very long holding period—5 years.

Senator Boschwitz. Oh. Tax on a dollar's worth of capital gains, it says Sweden 39.4 percent.

Suppose, Dr. Hatsopoulos, that we put into the bill—you know, there is some concern that there is a distribution table and that this bill, if passed as is, will help people under $10,000 to the tune of 62 percent; people under $20,000, $10,000 to $20,000 in income, I think, will be helped 18 percent. Then from there on up it is in the 5 to 6 percent category.

The administration's Treasury, too, helped the people in the lower categories to about the same degree, helped the people in the middle category where most of the people are found to a slightly lesser degree. Instead of 5 or 6 percent, it was 3 or 4 percent or something like that. Then it helped people in the $100,000 and above 10 or 12 percent and in the $200,000 and above, 13.6 percent. Obviously, if you help people in the $200,000 or above 13.6, you are saving a lot more bucks than you are if you help somebody under $10,000, 62 percent.

If that was found to be objectionable, in the sense that the great middle class is carrying the water once again, and the people above and below are getting the benefits—in the event that we change capital gains rates, they say that 75 percent of the benefit would accrue to people whose incomes exceed $200,000. My answer to that was that there is so little money collected from capital gains taxes anyway—$13, $14 billion, which is a small percentage of overall tax collections and small percentage, of income tax collections, that it would not change those figures terribly much.

Also, it is interesting that the distribution table was made so that it reflects what will happen in 1988. If you put in a 2-year holding period, it would not change the distribution table. So it occurred to me that maybe we should have a lower rate in the event there is a 2-year holding period. There would not be any impact on income of the Federal Government, at least of these tables that we are considering.

There would not be any income impact if we had a 5-year holding period. Tables only go 5 years. So that let us say we had a 2-year holding period and had a 40-percent exclusion or 50-percent exclusion under the existing rates. Well, let us say we had a 30-percent exclusion on a 2-year holding period and a 50-percent exclusion or a 60-percent exclusion on a 5-year holding period. What would you think of that?

Dr. Hatsopoulos. I would think that is a great improvement over the current proposal.

Senator Boschwitz. Fooling around with that.

I see that capital gains is taxed on the average in the United States 27 percent; in France, 6.2 percent; West Germany, 5.8 percent; Italy, Japan, zero. I guess Korea, which is not on here, is zero. So that is very helpful.

Oh, I see. So that Malaysia, Singapore, South Korea, Taiwan, Hong Kong, nothing. Indonesia, which is not as big.

All right. Thank you very much.

Panel No. 3 is Dr. Robert S. McIntyre and Mr. Joseph Minarik.

Mr. McIntyre, would you begin?

STATEMENT OF ROBERT S. MCINTYRE, DIRECTOR OF FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE, WASHINGTON, DC

Mr. McINTYRE. Mr. Chairman, I appreciate the opportunity to be here on behalf of Citizens for Tax Justice. Our coalition represents tens of millions of Americans who have a very major stake in the tax reform bills now pending in the Congress. They have a stake in the tax cuts that most of them will receive, they have a stake in getting the freeloaders out there—the so many big companies and so many rich individuals who are not paying taxes—to start paying again; and they have a stake in the improved economy that tax reform promises to give us.

As I listened to the witnesses—today, maybe I do not attend enough Senate hearings—but I must say I find it to be an outrage that people would come in here, first of all, and say that they support the Senate tax plan, and yet they are arguing for undermining it. And it seems to me also outrageous to come in and say that they are representing the swashbuckling entrepreneurs of America and then argue that what they need is a subsidy or a "bias" in the Tax Code for the people they claim to represent.

The Finance Committee bill, with its top rate of 27 percent, works for one reason and one reason only, and that is that it closes down the largest single tax break for upper income individuals in the current Tax Code. Without changing capital gains, you cannot come up with a fair distribution of the tax burden and have a rate anywhere near 27 percent.

In our testimony on page 2, we have a graph which details how much the capital gains exclusion is worth currently to taxpayers in various income classes. As you can see, until you hit the very top income group, capital gains is trivial. For the 88 percent of Americans who make less than $50,000 a year, the capital gains break is worth an average of $20 each.

Senator BOSCHWITZ. Eighty-eight percent of Americans are what?

Mr. McINTYRE. Eighty-eight percent of Americans who earn less than $50,000 every year save on average from the capital gains exclusion $20.

When you go above $200,000, however, you find the average savings to be $42,000 a year. A recent Treasury study looked at Americans who are not paying taxes but who make a great deal of money. It found that there were 30,000 people making more than $250,000 each who pay nothing or virtually nothing in Federal income taxes. Half of the reason why they do not pay taxes is the capital gains exclusion; it sheltered almost half their income.

Now given these distributional facts, we have to ask why is it that we even hear people talking about keeping a tax break for capital gains. The answer that is usually given is that the capital gains differential, as it was changed in 1978, has been helpful to venture capital and to entrepreneurialism and has helped the economy. There are fears expressed by some, that to treat capital gains the same as any other kind of income would stifle the entrepreneurial spirit and reduce the supply of venture capital.

We do not think those fears are justified; in fact, we think the Senate bill is very good for growing businesses and small businesses.

Now, if you look at the facts, you will find that certainly venture capital has played a role in helping certain areas of the country—in particular, Silicon Valley, Route 128 in Massachusetts, and so forth.

Senator Boschwitz. Have you ever been in business, Mr. McIntyre?

Mr. McIntyre. My wife is in business, Senator.

Senator Boschwitz. I did not ask about——

Mr. McIntyre. Well, I help her in her business, if that is what you mean.

Senator Boschwitz. What kind of business does she have?

Mr. McIntyre. She is an artist. She creates new and wonderful works of art.

Senator Boschwitz. I see.

Mr. McIntyre. It is a risky business, but she enjoys doing it and is very successful at it.

Now if you look at what happened to the electronics industry and venture capital, you find one thing is very clear: Venture capital did not create the high technology electronics industry; quite the opposite.

Senator Boschwitz. Have you ever had any venture capital, Mr. McIntyre?

Mr. McIntyre. I have invested in my wife's business, if that is what you mean, tens of thousands of dollars. I would call that venture capital. I suppose I am not a big enough player to compete with some of the people here like the previous witness who has millions of dollars' worth of IBM stock, but I am not sure that is venture capital, either.

Senator Boschwitz. Mr. McIntyre, do not make any remarks that inflame the chairman of the committee.

Mr. McIntyre. I do not want to. The previous witness brought that up himself, actually, Senator.

Senator Boschwitz. No; the chairman of the committee is before you. Do not—I mean, you know, be reasonable here, Mr. McIntyre, and then we will listen to you. Continue.

Mr. McIntyre. I am trying to be reasonable, Senator.

What I am trying to point out is that it was demand for high technology products that created Silicon Valley and Route 128 in Massachusetts and venture capital followed that boom in demand for things like the personal computer and so forth. This has been documented by a 1985 Congressional Budget Office report, which shows quite clearly that it was the demand for new products which preceded the boom in venture capital in the high-tech industry.

After 1978, there was an increase in venture capital, which followed the increasing demand for high-tech products, but it was overwhelmingly dominated by entities, institutions, and non-Americans who were not affected by the 1978 changes. In fact, data that was compiled by one of the earlier witnesses shows—and it is shown graphically on page 4 of our testimony—that since 1978, the increase in venture capital has come almost entirely from insitutions and people who were not affected by the 1978 changes. Pension funds, other tax-exempts, foreigners, insurance companies, banks, and other corporations have supplied 87 percent of the increase in venture capital since 1978. Individual investors, who might have gained added incentive, supplied only 13 percent.

Senator BOSCHWITZ. Well, I have seen that before. What is this applied to? This is all new businesses or just businesses that have gone public or what?

Mr. MCINTYRE. This is the increase in venture capital funds, which is what is covered by "Venture Capital Journal." In addition, the previous witness pointed out that some of the venture capital stock comes from family members and friends. He does not cover that in his reports, wisely, I think, because I do not think it is something that would be significantly affected by the capital gains tax.

Senator BOSCHWITZ. Is the venture capital that is measured here, does that apply to companies that have gone public?

Mr. MCINTYRE. Not necessarily.

Senator BOSCHWITZ. Does it apply to——

Mr. MCINTYRE. Well, it includes startup companies that have gone into the venture capital markets, which is an organized market——

Senator BOSCHWITZ. Oh

Mr. MCINTYRE [continuing]. And have sought funds.

In addition——

Senator BOSCHWITZ. Did it include your wife?

Mr. MCINTYRE. No; my wife is one of the people that are in the remaining portion that was discussed earlier today, where they received funds from their relatives. And I can tell you that the opportunity for capital gains breaks did not occur to me when I was putting money into my wife's business. It probably does not occur to most relatives.

Senator BOSCHWITZ. Well, I must tell you that I have seen this before and I would suggest to you that most of the new businesses that are formed do not go into the venture capital market.

Mr. MCINTYRE. Of the new sources of venture capital funds, about two-thirds comes from this area; the rest of it comes from relatives and friends, and, of course, borrowing from the bank, which no one would think of as a venture capital. It is not an investment; it is a loan.

Now, why is it that so much tax-exempt money——

Senator BOSCHWITZ. It has to be paid back.

Mr. MCINTYRE. Yes; but it is not the kind of funds that are affected by capital gains, certainly. Banks pay no taxes for quite different reasons than capital gains breaks.

Why is it that so much tax-exempt money has gone into the venture capital area? It is quite clear the rate of return is extraordinarily high. Venture funds now pay on average 25 percent or more annual rates of return. That is netting out the winners against the losers. When you can offer that kind of a return on an investment, you are going to attract funds, even from conservative types of investors like pensions and endowments. That is exactly what has happened.

Why did pension funds not go into this earlier, you might ask? The answer is quite simple. The law did not allow them to do it until 1978 when the ERISA regulations were changed to allow pension funds to get into this area. State pension rules were changed as well

So it was a change in regulation that was the key factor allowing this kind of money to get into venture capital.

It seems to me that the data presented by the people who were here earlier makes clear that capital gains has not been a significant factor in increasing the size of the venture capital pool over the last 6 years. Capital gains breaks have, however, played a major role in spurring wasteful tax-shelter investments that have diverted resources away from productive uses and into things like empty office buildings, llamas, and collectibles. Embryonic cattle breeding is a favorite shelter these days.

Senator BOSCHWITZ. Embryonic what?

Mr. MCINTYRE. Embryonic cattle breeding. It's a process where you get one cow to have very many calves and the investors are entitled to capital gains breaks and investment credits. Then we have a dairy crisis as a result. But that is another story.

The point is that we have wasted a great deal of money by giving tax subsidies across the board to capital gains, and we have gotten almost nothing in the way of venture capital in return for it. That is one of the reasons we think that tax reform will be good for small business and for real growing productive companies. Tax reform will stop the diversion of our resources into things that do not make any sense, which is what the current system of tax breaks for this and that, including capital gains, has done.

Senator BOSCHWITZ. Thank you very much.

[The prepared statement of Mr. McIntyre follows:]

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STAFF
Robert S. McIntyre

1313 L Street NW
Washington, DC 20005
(202) 898-3369

Statement of Robert S. McIntyre
Director, Federal Tax Policy
Citizens for Tax Justice
Before the Senate Committee on Small Business
Concerning Capital Gains Tax Reform & Small Businesses
June 4, 1986

I appreciate the opportunity to appear before the Committee today on behalf of Citizens for Tax Justice. Our coalition of labor, public interest and grassroots citizens groups represents tens of million of average American taxpayers who have a vital stake in restoring fairness and economic common sense to our nation's tax laws.

This week, the Senate will begin debate on the historic tax reform bill recently approved by the Senate Finance Committee. We enthusiastically support that bill, just as we vigorously supported its counterpart passed by the House last December.

The bill reported by the Finance Committee provides for a top personal tax rate of just 27 percent--only half the present top marginal rate. The key reason why the Finance Committee was able to achieve such a low top rate without losing excessive amounts of revenue or tilting its personal tax reductions grossly in favor of the best-off taxpayers is that the Committee's bill ends the preferential treatment of capital gains.

The 60-percent exclusion for capital gains is the single largest tax break for wealthy individuals in the current tax code.

- According to the Joint Committee on Taxation, the capital gains exclusion is worth a staggering $42,683 a year each to individuals making more than $200,000.[1]
- The Treasury Department reports that the capital gains tax break exempts from tax almost one-quarter of the earnings of individuals with incomes exceeding $250,000. And rich people who pay virtually no tax manage to shelter almost half their incomes with the capital gains preference.[2]

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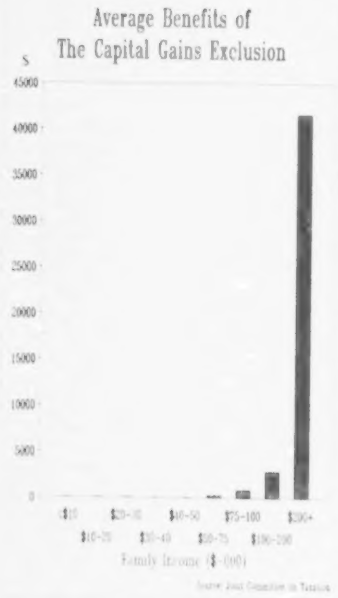
[1] *See* Joint Commmittee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1987-1991* (JCS-7-86), March 1, 1986.

[2] *See* Statement of Ronald A. Pearlman, Assistant Treasury Secretary, in "High-Income Taxpayers and Related Partnership Tax Issues," Hearing before the Oversight Subcommittee of the House Ways and Means Committee, 99th Cong., 1st Sess. 15, 27 (Sept. 20, 1985).



Average Benefits of The Capital Gains Exclusion

Source: Joint Committee on Taxation

- Almost 90 percent of the benefits from the capital gains exclusion go to the top two percent of all taxpayers. Indeed, three-quarters of the tax savings from capital gains breaks are enjoyed by 374,000 individuals whose incomes exceed $200,000.[3]
- The 88 percent of Americans who earn under $50,000 a year get less than 5 percent of the benefits of the capital gains exclusion. In fact, the *average* tax saving for these families from the capital gains break is only $20 a year.[4]
- As the members of this Committee know, the tax savings for the wealthy from the capital gains exclusion were significantly expanded in 1978, when the exclusion was increased from 50 percent to 60 percent. As a result, the IRS recently reported that there was no growth at all in taxes on capital gains (in constant dollars) between 1978 and 1982, despite growth in the overall economy. Capital gains taxes as a share of total personal income taxes fell by 8 percent over the same period.[5]

The 1978 reduction in capital gains taxes is sometimes given credit for the growth in the venture capital industry and the rise of entrepreneurship (with resulting contributions to job creation and technological innovation). Fears have been expressed by some that the Finance Committee's proposal to eliminate the capital gains exemption could hurt the venture capital industry, small and growing businesses, and the economy as a whole. We believe that such fears are unjustified; indeed, we are convinced that the Senate tax plan will be a major step toward increased productive investment and a healthier, more productive economy.

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[3] *See* Joint Committee on Taxation, supra, note 1.

[4] *Id.*

[5] *See* Internal Revenue Service, "Sales of Capital Assets, 1981 and 1982," in *SOI Bulletin*, Winter 1985-86, page 65 (Jan. 1986).

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Certainly, the venture capital industry has played a useful, albeit small, role in economic development, particularly in areas like Silicon Valley in California and Route 128 in Massachusetts. But venture capital didn't create the high-tech electronics industry. Quite the opposite: it was customer demand for new high-tech products, most recently personal computers, that spurred and sustained the boom in venture capital.

- A 1985 Congressional Budget Office report shows that the increase in venture capital investment was led by a rapid surge in the demand for high-technology electronic products after the 1974-75 recession and, moreover, that the venture capital boom was underway well before the 1978 capital gains tax reduction.[5]

And it wasn't tax breaks that made venture capital investments attractive. To the contrary, almost all the increase in venture capital investment that occurred after 1978 came from pension funds and other entities that were not affected by the 1978 reduction in individual capital gains taxes.

- Significant pension fund investment in venture capital began after the U.S. Department of Labor revised its restrictions on pension investments under the Employee Retirement Investment Security Act in 1978. Previously, the Department had taken the position that venture capital was "too risky" an investment for private pension funds. After 1978, however, the Department of Labor changed the rules to allow pensions to place a portion of their assets in venture capital. Similar changes were made by many states, allowing public pension funds to engage in venture capital investments.

- As a result of these changes, some 36 percent of the increase in venture capital investment from 1978 to 1984 was supplied by pension funds--to which, of course, the 1978 capital gains cuts were irrelevant.

- Other tax-exempt entities and foreigners--also indifferent to the 1978 tax cuts--supplied 23 percent of the 1978-84 increase in venture capital.

- Another 28 percent of the increased venture capital came from corporations, such as life insurance companies and banks, many of which already paid little or nothing in taxes and which, in any event, were not significantly affected by the 1978 capital gains changes.

- In total, then, a mere 13 percent of the increase in venture capital investment from 1978 to 1984 came from individual investors. Indeed, since 1978 the share of venture capital supplied by individual investors who might have gained added "incentive" from the 1978 capital gains cut, has declined markedly.

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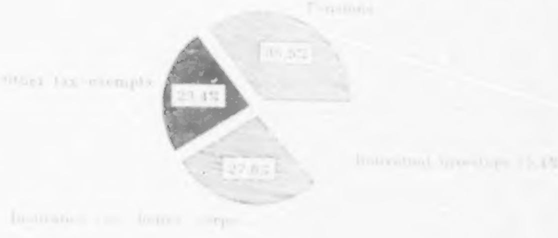
[5] Congressional Budget Office, *Federal Support for High-Technology Industries* (June 1985), pp. 51-55.

4

Sources of the Increase in Venture Capital, 1978 to 1984



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The dominance of the venture capital market by pension funds and other tax-exempt or quasi-tax-exempt entities makes clear that the real economic incentives for venture capital investment will continue to draw investment dollars whatever changes are made in capital gains taxation.

- Venture capital funds now offer an average annual rate of return of 25 percent or more—profits that will attract investment even without a tax break.

Although other factors have far and away dominated the growth of venture capital, expanded tax breaks for capital gains have played a major role in the sharp increase in wasteful tax shelters in recent years. Indeed, one of the primary goals of most tax-shelter investments is to convert ordinary taxable income into lightly-taxed capital gains.

Stopping this waste of our resources and getting more money to flow toward productive, growing businesses is an important goal of tax reform. And the Finance Committee's overall tax reform plan, including its elimination of the capital gains exclusion, promises to increase productive investment in new, young and growing firms.

- Lower marginal tax rates, equal treatment of capital gains and regular income, and tough restrictions on tax shelter "losses" will curb wasteful speculation in collectibles, llamas, unneeded commercial buildings, etc.

onic cattle breeding, and the like. Instead, investors will be forced to base their decisions on intrinsic economic merits rather than tax consequences--a change that will redirect investment funds into productive investments that create jobs and economic growth.

- Requiring the General Electrics and AT&Ts and other giant corporate freeloader to start paying taxes again will help put small businesses and entrepreneurs on a more equal competitive ground with the big established firms.

- Finally, even if there really were some magic in 1978's cut in the top capital gains rate to 28 percent, the Senate tax plan's top marginal rate of 27 percent is lower than that amount.

When people talk about tax reform, they usually--and rightfully--focus on the need to restore equity to the tax laws. By curbing loopholes and making the tax freeloaders start paying their share again, tax reform offers a fair shake to the millions of hardworking Americans who pay their taxes year in and year out. But tax reform also has an important economic message: It means more economic freedom, more reliance on the dynamism of the marketplace, and less attempts to dictate economic decisionmaking through the fine print of the Internal Revenue Code.

Thus, those who oppose reform as "bad for business" actually are making a very startling assertion. In essence, their claim is that a more free-market economy would hurt investment and reduce our nation's ability to compete in world markets.

Yet the disappointing results of our current tax "incentive" system can be seen all around us. Empty office buildings built with tax-shelter money dot the landscapes of most of our major cities. Tax-shelter farmers indifferent to real profits drive thousands of real farmers into bankruptcy. Cash-rich megacorporations buy their competitors in an orgy of mergers and takeovers.

Since the big expansion in corporate tax breaks was enacted in 1981, business equipment investment, excluding autos and computers (which gained no added tax incentives from the 1981 changes), has increased at an annual rate of just 1.9 percent--less than one-third the annual rate of increase in such investment from 1976 to 1980. The U.S. current-account trade balance has gone from a surplus in 1981 to a deficit in excess of $120 billion a year today.

- The annual reports of the corporations themselves tell the story even more clearly than do the aggregate data. Those giant, profitable companies that paid no tax between 1981 and 1984 cut investment by 4%, cut employment by 6% and cut exports by 15%--even as they embarked on a spree of mergers and higher dividend payouts and raised their top executive salaries by 52%.[7]

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[7] *See* Citizens for Tax Justice, *Money for Nothing: The Failure of Corporate Tax Incentives 1981-1984* (Feb. 1986) and *Undermining America: Corporate Loopholes and the Trade Deficit* (March 1986).

Sure, the big corporations that have been paying no taxes and the tax-shelter promoters may be reluctant to see their handouts taken away. But reform will be very good for the thousands of small businesses and even many large companies that have been unable to parlay loopholes into exemption from taxes.

In fact, taxpaying American businesses will be among the biggest winners under a reform bill that trades in special tax breaks for much lower rates. Corporations that now pay a top rate of 46 percent of their earnings in taxes will, under the Senate bill, pay a top rate of only 33 percent. Unincorporated businesses that now face a 50 marginal rate will see the top rate drop to 27 percent.

Restoring a level playing field to the American economy and putting more money into consumers' pockets is hardly "anti-business." That's why a broad coalition of American businesses and trade associations--ranging from General Motors to the Sara Lee Corporation to the National Federation of Independent Businesses--have endorsed the tax reform bills now pending in Congress.

The tax reform bill reported by the Senate Finance Committee is a truly monumental achievement. Elimination of the capital gains exclusion is a critical part of the bill--essential not only to the 27-percent top tax rate, but indeed to the entire structure of the plan. We urge the members of this Committee--and all the members of the Senate--to support the Finance tax reform bill on the Senate floor.

Senator BOSCHWITZ. Mr. Minarik.

STATEMENT OF JOSEPH J. MINARIK, SENIOR RESEARCH ASSOCIATE, URBAN INSTITUTE, WASHINGTON, DC

Mr. MINARIK. Thank you, Mr. Chairman. I have a brief prepared statement I would like to read into the record.

Some commentators have claimed that the Senate Finance Committeee's tax bill would have severe detrimental economic effects. Among the specifics cited in these claims is the bill's repeal of the exclusion from tax of 60 percent of long-term capital gains. In my opinion, this concern is baseless. In this statement, I hope briefly to explain why.

First, much of the tax advantage to capital gains remains. Capital gains taxation has always been a rough-justice compromise between the taxpayer and the Treasury. Precisely accurate tax treatment is administratively infeasible, and the compromise that we have struck includes some benefits for both parties. While it is often forgotten, important benefits for the taxpayer will remain even after the exclusion is repealed.

Probably the most important advantage of recipients of capital gains is deferral; the tax on a capital gain is postponed, after the gain is accrued, until the gain is realized. In contrast, income from capital that is distributed in the form of dividends or interest is taxed currently. Because of deferral, the gain can compound itself without tax.

Further, realization of the gain and payment of the tax are postponed until a time of the taxpayer's choosing.

Senator BOSCHWITZ. Would you be in favor of allowing complete deductibility of capital losses in that case? Do you cover——

Mr. MINARIK. May I postpone that one paragraph?

Senator BOSCHWITZ. Fine. Fine.

Mr. MINARIK. Thank you.

The taxpayer can time the realization of his gains to match significant deductible expenses in order to minimize the the tax due.

Please note that the unlimited deductibility of capital losses—I wrote with extreme prescience—against ordinary income would result in a wholesale elimination of tax on wealthy investors with or without a capital gains exclusion. Investors with diversified portfolios could hold their gains and realize enough of their losses to offset fully all of their income from other sources, and pay no tax. Thus, unlimited deductibility of losses is not a necessary accompaniment to elimination of the exclusion, contrary to the opinions expressed by some observers.

Senator BOSCHWITZ. I would agree with that.

Mr. MINARIK. Finally, accrued capital gains held until death can be passed on to the investor's heirs free of any income tax. Again, this is a significant advantage relative to income received in the forms of dividends or interest.

Against these advantages to capital gains, there are some disadvantages. One is that nominal capital gains are taxed in full, without any correction for inflation. There are two points that must be kept in mind on this issue.

First, advocates of more lenient capital gains taxation always mention the inflation disadvantage but usually ignore the corresponding advantages of deferral, the discretion of timing of realization, and the death escape.

Senator BOSCHWITZ. The death escape?

Mr. MINARIK. I like that one, too, Mr. Chairman.

Second——

Senator BOSCHWITZ. I did not get the escape part until the next page. I am not looking forward to escaping quite in that manner, I might tell you. [Laughter.]

Mr. MINARIK. Second——

Senator BOSCHWITZ. What is that nominal capital gains tax in full? What do you mean by that?

Mr. MINARIK. If you invested $100 in stock 10 years ago and it were worth $200 today, the price level had approximately doubled over that period of time. So you still had 100 dollars' worth of purchasing power in the year in which you made the investment. So there is no real gain. All of the gain corresponds to the increase in the price level.

Second, when offered a precise correction of the inflation problem through indexation in Treasury I, the investment community pronounced itself dissatisfied. Thus, one must presume that inflation is merely an argument investors use to request general relief, not a problem that they really want to solve.

Let me add, Mr. Chairman, here that it is sometimes proposed as a solution to this inflation problem to offer a capital gains exclusion, such as we have now in the current law. If you consider it for an equal amount of revenue loss, the capital gains exclusion is better for assets that are held over a short time—relatively—than is inflation indexing. Also it is better for large gains than it is for small gains.

So in other words, if you look at the capital gains exclusion as a builder kind of an incentive—an incentive to build rather than to merely trade assets quickly—it has precisely the opposite effect in comparison with the correct system of inflation indexing of capital gains.

Senator BOSCHWITZ. Would you like—you know I suggested to the witness preceding—Mr. McIntyre—that you have a very long holding period. How would that appeal to you?

Mr. MINARIK. Let me suggest, Mr. Chairman, that when you look at the group that favors some kind of preference for capital gains, you wind up with some very strange bedfellows. Let me suggest that this is one of the things that brings that out. If you have a very long holding period for capital gains at the end of which time you give a large exclusion, that would seem to be a good thing to do to make people invest for the long haul. It also has the effect that economists would find negative that it would induce individuals to buy something and then not trade it, even if a better opportunity arose.

A lot of the supposed advantage of the lower capital gains rate——

Senator BOSCHWITZ. My friends would—if a better opportunity arose, I am not sure that my friends who I know—and I myself, I would probably take the better opportunity. I would go out and borrow money and take the other opportunity.

I know that Mr. McIntyre does not think that is very creative capital-wise.

Mr. **Minarik**. Without getting into the heavy mathematics of it, you could make a calculation that would suggest that at any given set of tax terms, you have an investment that is giving you a yield of, say, 5 percent and you have an alternative that could get you 10 percent, say, it is possible that under some circumstances the amount of the capital gains tax that you would have to pay, if you realized your low yielding investment, would give you sufficiently less principal to reinvest in the higher yield, that you would be better off staying where you are at a 5-percent yield than selling and reinvesting in a 10-percent yield.

That is what is referred to as a lock-in effect. A lot of the——

Senator **Boschwitz**. I would go out and borrow the money myself.

Mr. **Minarik**. Well, some people do not always have the security they need to borrow the money.

The other thing is, from an economist's point of view, what you want to do is move that money from the low-yielding opportunity to the higher-yielding opportunity. That is what makes the economy go, as you move resources from bad places to good places. If you have this kind of a lock-in effect, you prevent that from happening. You also have the effect of reducing tax revenues, to some degree, because people do not realize gains.

Point two: The increase in capital gains tax rates in the Finance Committee bill is hardly unprecedented. The top rate on capital gains in the bill would be 27 percent, if the Congress can tighten the tax base somewhat further and eliminate the phaseout of the benefit of the bottom bracket rate, which pushes it up to the 32-percent range.

When the top rate on capital gains was reduced to 28 percent in 1979, the investment community greeted the change with hosannas; many salutary economic effects have since been causally assigned to that change. If a 28-percent maximum rate in the high-inflation atmosphere of 1978 was so marvelous, a 27-percent top rate in the low-inflation environment of 1986 cannot be all that bad.

Further, any taxpayers who find the increase too much for their liking have been allowed the opportunity to realize their gains before the end of 1986, at the current law tax rates.

It is true that increases in capital gains tax rates in low- and middle-range brackets will increase more sharply than the top rate. But the level of the new rate structure is low enough that no economic harm should transpire.

Senator **Boschwitz**. Have you factored in the State taxes? The State taxes would apply to the entire gain—State taxes, let us say, in our State of 14 percent. So that in the event you are in the 32-percent bracket, a married taxpayer between $75,000 and $145,000, the capital gains rate would be 40½, 41 percent something like that.

Mr. **Minarik**. Well, there is a tremendous variation as you know——

Senator Boschwitz. Yes.

Mr. Minarik [continuing]. In capital gains tax rates.

There is a tremendous difference in rates across the States. The other thing I would suggest, Mr. Chairman, is the following:

Because the Federal tax base has broadened, States will have an opportunity, to some degree depending on how broad their tax bases are now, to follow suit. To the extent that they do so, they will be able to lower their rates, as well.

Senator Boschwitz. I think that is going to happen.

Mr. Minarik. There are other factors in the Finance Committee bill that are highly favorable to businesses. It is misleading to point to one aspect of the tax bill and ignore all others, especially in the instance of capital gains taxation.

Senator Boschwitz. Well, you know, I agree with that. As I pointed out to the other witness, Mr. Lloyd, you cannot just single that out.

Mr. Minarik. The marginal rate reductions, at both the individual and the corporate level, are a tremendous benefit to those businesses that are intended to make money. Obviously, at the individual level, the rate cuts more than offset the broadening of the tax base, to the tune of about $100 billion over 6 years. Even at the corporate level, the value of the rate cuts exceeds the $100 billion in increased taxes. Thus, individuals and businesses whose income is now taxable stand to benefit handsomely under the bill.

This has important implications for businesses. The tax burden on income generated in the corporate sector would be lower, not higher, because the 13 percentage point cut in the corporate tax is greater than the 7 percentage point increase in the top capital gains tax rate—and, of course, the tax burden on dividend income at the individual level would be reduced substantially.

If a corporation increases its earnings prospects, its share value will increase by more dollars because of the lower corporate tax rate, and that increase in value will more than offset the increase in the capital gains tax. This is important not only for corporations, but also for small businesses that plan to incorporate when they turn the corner to success.

The greater initial valuation of promising business firms when they go public will more than compensate their entrepreneurs for the higher capital gains tax rate that they will pay on their proceeds of incorporation.

Just very simply, Mr. Chairman, if $1 is added to the income of the corporation, it then pays a 33-percent corporate tax rate on that appreciation in value, which is realized as a capital gain to the individual at 27-percent rate. Of that original dollar, you have got about 49 cents left, after taxes to the individual.

Under the current system, with a 46-percent initial corporate bite and then a succeeding 20-percent capital gains rate, even though the last bite is smaller, the total burden on that income reduces what is left down to about 37 cents.

So when you consider the whole——

Senator Boschwitz. How did you figure that one out? If you take 46 cents away, you have 54 cents left.

Mr. Minarik. Right. If the individual were to realize that as a capital gain——

Senator Boschwitz. Assuming that it were all capital gain.

Mr. Minarik. If it were a dividend, the tax burden would be much higher.

Senator Boschwitz. If it were all a capital gain, then there would be an 11-percent tax. So it would be 57 percent. What did you say?

Mr. Minarik. The individual would get 80 percent of the 54 cents that are left over, after the corporate bite. So 80 percent of the 54—I may have made a mistake— —

Senator Boschwitz. Forty-three.

Mr. Minarik. Forty-three OK.

Senator Boschwitz. What did you say?

Mr. Minarik. I said 37, which just goes to show you what you can do for——

Senator Boschwitz. That is presuming that there is no basis in the stock at all?

Mr. Minarik. That is taking that additional margin of income as being a capital gain.

Senator Boschwitz. Yes.

Mr. Minarik. Under the Senate proposal, it would be substantially larger than that because the initial bite, the 33-cent bite would be much smaller. So even with the 27 bite on what is left, the total of the two bites would be smaller.

Let me just add: For small businesses, there are still further benefits. The much greater personal exemptions and standard deductions will benefit small businesses that provide their owners with a modest living. Self-employed individuals will be allowed to deduct half of the cost of health insurance for themselves and their families. And for businesses with prospects for growth, rules governing incentive stock options have been liberalized.

The fourth main point: Profit-making businesses would benefit from more neutral business tax rules. There are many aspects of tax reform that would indirectly but meaningfully benefit small businesses and others that aim to make a profit.

The current tax rules, of which the capital gains exclusion is a key part, enable and encourage tax sheltering. Tax shelters waste capital; they divert it away from businesses that offer greater returns to society but lesser tax benefits. Every dollar of resources that goes into building another empty office tower could be doing something useful. Under the Senate bill, those dollars of resources would be available to other businesses that plan to make their money in the marketplace.

Let me add, Mr. Chairman, it is not necessary if we cut down on investments in tax shelters, that the people who would have put the money in the tax shelters go out and invest in venture capital firms. If they go out and put their money into alternative, safe investments like bonds, they are going to increase the amount of funds that are available in the market so that people can borrow those funds and put them into venture firms.

Another thing that you want to keep in mind—and I am anticipating myself somewhat—is that if money moves out of tax shelters into safe investments, it is going to reduce interest rates, which makes it easier for profit-making businesses to borrow when they need money, and it also will have the effect of increasing the relative advantage of venture investment.

Senator BOSCHWITZ. Why do you not summarize.

Mr. MINARIK. In the final analysis, tax reform, including repeal of the capital gains exclusion, is a good deal for business. Full taxation of capital gains is one of the targeted tax law changes that must be made to pay for tax reform. Whenever the tax base is broadened, there is some localized pain; but the general benefit in a fundamental tax reform that drastically reduces tax rates will overwhelm that pain.

[The prepared statement of Mr. Minarik follows:]

STATEMENT OF JOSEPH J. MINARIK, SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE

CAPITAL GAINS TAXATION AND SMALL BUSINESS

Some commentators have claimed that the Senate Finance Committee's tax bill would have severe detrimental economic effects. Among the specifics cited in these claims is the bill's repeal of the exclusion from tax of 60 percent of long-term capital gains. In my opinion, this concern is baseless. In this statement, I hope briefly to explain why.

1. Much of the tax advantage to capital gains remains. Capital gains taxation has always been a rough-justice compromise between the taxpayer and the Treasury. Precisely accurate tax treatment is administratively infeasible, and the compromise that we have struck includes some benefits for both parties. While it is often forgotten, important benefits for the taxpayer will remain even after the exclusion is repealed.

Probably the most important advantage of recipients of capital gains is deferral; the tax on a capital gain is postponed, after the gain is accrued, until the gain is realized. In contrast, income from capital that is distributed in the form of dividends or interest is taxed currently. Because of deferral, the gain can compound itself without tax.

Further, realization of the gain and payment of the tax are postponed until a time of the taxpayer's choosing. The taxpayer can time the realization of his gains to match significant deductible expenses in order to minimize the tax due.

(Please note that the unlimited deductibility of capital gains against ordinary income would result in wholesale elimination of tax on wealthy investors with or without a capital gains exclusion. Investors with diversified portfolios could hold their gains and realize enough of their losses to offset fully all of their income from other sources, and pay no tax. Thus, unlimited deductibility of losses is not a necessary accompaniment to elimination of the exclusion, contrary to the opinions expressed by some observers.)

Finally, accrued capital gains held until death can be passed on to the investor's heirs free of any income tax. Again, this is a significant advantage relative to income received in the forms of dividends or capital gains.

Against these advantages to capital gains, there are some disadvantages. One is that nominal capital gains are taxed in full, without any correction for inflation. There are two points that must be kept in mind on this issue. First, advocates of more lenient capital gains taxation always mention the inflation disadvantage but usually ignore the corresponding advantages of deferral, the discretion of timing of realization, and the death escape. Second, when offered a precise correction of the inflation problem through indexation in Treasury I, the investment community pronounced itself dissatisfied. Thus, one must presume that inflation is merely an argument investors use to request general relief, not a problem that they really want to solve.

2. The increase in capital gains tax rates in the Finance Committee bill is hardly unprecedented. The top rate on capital gains in the bill would be 27 percent (if the Congress can tighten the tax base somewhat further and eliminate the phaseout of the benefit of the bottom bracket rate). When the top rate on capital gains was reduced to 28 percent in 1978, the investment community greeted the change with hosannas; many salutary economic effects have since been causally assigned to that change. If a 28 percent maximum rate in the high-inflation atmosphere of 1978 was so marvelous, a 27 percent top rate in the low-inflation environment of 1986 cannot be all that bad. Further, any taxpayers who would find the increase to much for their liking have been allowed the opportunity to realize their gains before the end of 1986 at the current law tax rates.

It is true that increases in capital gains tax rates in low- and middle-range brackets will increase more sharply than the top rate. But the level of the new rate structure is low enough that no economic harm should transpire.

3. Other factors in the Finance Committee bill are highly favorable to business. It is misleading to point to one aspect of the tax bill and ignore all others, especially in the instance of capital gains taxation. Other changes in the bill are extremely favorable to business.

The marginal rate reductions, at both the individual and the corporate level, are a tremendous benefit to those businesses that are intended to make money. Obviously, at the individual level, the rate cuts more than offset the broadening of the tax base, to the tune of about $100 billion over six years. Even at the corporate level, the value of the rate cuts exceeds the $100 billion in increased taxes. Thus, individuals and businesses whose income is now taxable stand to benefit handsomely under the bill.

This has important implications for businesses. The tax burden on income generated in the corporate sector would be lower, not higher, because the 13 percentage point cut in the corporate tax is greater than the 7 percentage point increase in the top capital gains tax rate--and of course the tax burden on dividend income at the individual level would be reduced substantially. If a corporation increases its earnings prospects, its share value will increase by more dollars because of the lower corporate tax rate, and that increase in value will more than offset the increase in the capital gains tax. This is important not only for corporations, but also for small businesses that plan to incorporate when they turn the corner to success. The greater initial valuation of promising business firms when they go public will more than compensate their entrepreneurs for the higher capital gains tax rate that they will pay on their proceeds of incorporation.

For small businesses, there are still further benefits. The much greater personal exemptions and standard deductions will benefit small businesses that provide their owners with a modest living. Self-employed individuals will be allowed to deduct half of the cost of health insurance for themselves and their families. And for businesses with prospects for growth, rules governing incentive stock options have been liberalized.

4. Profit-making businesses would benefit from more neutral business tax rules. There are many aspects of tax reform that would indirectly but meaningfully benefit small businesses and others that aim to make a profit.

The current tax rules, of which the capital gains exclusion is a key part, enable and encourage tax sheltering. Tax shelters waste capital; they divert it away from businesses that offer greater returns to society but lesser tax benefits. Every dollar of resources that goes into building another empty office tower could be doing something useful. Under the Senate bill, those dollars of resources would be available to other businesses that plan to make their money in the marketplace.

The reduction of capital demands for tax shelters would reduce interest rates. So would the restraints on deductibility of consumer borrowing. And so would lower tax rates themselves. When tax rates go down, lenders can demand lower interest rates and receive the same after-tax reward for their funds. At the same time, the lesser value of interest deductions would force borrowers to demand lower interest rates to hold their after-tax costs of funds constant. So lower tax rates put downward pressure on interest rates from both sides of the transaction.

The tax rate effects for small business could be especially important. Keep in mind that the after-tax cost of borrowing for a major corporation in the 46 percent tax bracket is only 54 cents on the dollar, while the cost for a small business after the tax deduction for interest could be 100 cents, or 89 cents in the bottom individual income tax bracket. Under the Senate bill, the after-tax costs of funds would be much more equal.

5. In the final analysis, tax reform, including repeal of the capital gains exclusion, is a good deal for business. Full taxation of capital gains is one of the targeted tax law changes that must be made to pay for tax reform. Whenever the tax base is broadened, there is some localized pain; but the general benefit in a fundamental tax reform that drastically reduces tax rates will overwhelm that pain.

Every interest that loses a tax preference will argue that it will be seriously hurt. And yet most interests want and would benefit from the lower tax rates. The trick that these interests are trying to achieve is to have tax reform pass with only their specific tax preferences exempted from the process. This is the cause of the "I'm for tax reform, but..." syndrome which is so much in evidence in the Washington these days.

The problem is that such pleas cannot be accommodated without destroying the process. Restoring one tax break raises the rates for everyone else, and causes them to cry louder for their preferences. If a further preference is restored in response to this greater pressure, the pressure increases still more. It is a self-destructive process. Legislators should keep that in mind when they contemplate concessions.

This is especially important, in my view, with regard to capital gains. Many advocates choose to ignore the benefits of tax rate reductions for other forms of business income. They argue that the capital gains tax break has some kind of a special, emotional role in spurring on risky activity. The Congress should remember that entrepreneurs are capable of making the tax computations; they know that the larger tax cuts for corporate income and for dividends and interest more than outweigh the higher taxes on capital gains. Losing out on this unprecedented opportunity for real tax reform would be a very high price to pay for stirring the visceral juices of some of the already wealthiest people in the United States.

In sum, a careful analysis of the facts indicates that elimination of the capital gains exclusion would still leave capital gains with important tax advantages, and that the tax rates on capital gains would still be well within the range of our recent historical experience. The economic benefits of the tax reform that elimination of the exclusion would allow would be enormous. The Senate should ratify the Finance Committee's bill so that this unprecedented opportunity can be realized.

Senator BOSCHWITZ. I hope you are right.

Mr. MINARIK. Let me leave it there, Mr. Chairman.

Senator BOSCHWITZ. Let me ask. Suppose that we were to—let me ask in reverse the question I asked Mr. Lloyd and Mr. Hatsopoulos. That is—suppose we were to return some kind of an advantage to capital gains. I presume that you both agree that the bill would not have lost its interest, that we should still vote for it, I presume?

Mr. MINARIK. I would have some definite preferences about what you do, if you decide you are going to do that. I think the best thing you could, do; in terms of fairness and neutrality among alternative investments, would be to allow indexation of capital gains.

Senator BOSCHWITZ. Indexation of the——

Mr. MINARIK. Of the basis for inflation.

And if you did that, it seems to me, that you would need to get some revenue back. I think that is obvious. And the way that would have to be done, I think, would be to introduce a new, higher top bracket in order to pay for it.

Senator BOSCHWITZ. Are you concerned at all—and you have seen the figures, I am sure; they have been pointed out to you and you have seen them—that when the capital gains rate went up very high, that collections went down very substantially—about 50 percent, as a matter of fact.

Mr. MINARIK. I am cited in the testimony of a later witness as someone providing some analytical foundation to the notion that increases in capital gains taxes have a substantial downward pressure on revenues. I would like to take exception to that citation. As a matter of fact, I brought three papers that I have written on the topic that I would like to have inserted into the record if I could.

Let me talk about what is involved——

Senator BOSCHWITZ. We would be happy to do that.

[Subsequent information was received and follows:]

Capital Gains Taxation in the Administration's Reform Plan

Testimony of

Joseph J. Minarik
Senior Research Associate
The Urban Institute

Before the

Subcommittee on Economic Stabilization
Committee on Banking, Finance, and Urban Affairs
U. S. House of Representatives

June 19, 1985

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CAPITAL GAINS TAXATION
UNDER THE ADMINISTRATION'S REFORM PLAN

Of the changes in the administration's tax reform proposal relative to the Treasury's original plan, those relating to capital gains taxation are surely among the most significant. Along with modifications to provisions relating to depreciation and taxation of income from oil and gas, the capital gains decisions have at least to some degree changed the character of the package.

In contrast to Treasury I, which would have taxed inflation-adjusted capital gains at ordinary rates, the administration's plan allows an exclusion equal to 50 percent of the nominal capital gain. Given the Treasury's proposed maximum rate, this gives the highest-income taxpayers a tax cut on their long-term gains, to 17.5 percent (that is, the 50 percent of capital gain that is taxed times the 35 percent ordinary maximum rate) from 20 percent (the 40 percent of capital gains now taxed times the maximum current-law rate of 50 percent). The exclusion, relative to indexation, is relatively more generous to those with relatively short-term gains, and to those with large gains. Those with small gains or losses, and those who have held assets over the last two decades of rapid inflation, would tend to be better off with Treasury I's indexation.

The capital gains exclusion in the current law has been widely criticized on tax policy grounds for some time. While the exclusion is sometimes justified as a compensation for inflation, it is far from precise, and as noted above drastically overcompensates those who realized gains over short periods with little inflation. The exclusion is also justified as an incentive to risky investment and capital formation, but much of its benefit is dissipated on tax shelters and assets that have little bearing on long-term economic growth. In light of this criticism, it is somewhat surprising that the administration receded from its earlier position of taxing precisely inflation-adjusted capital gains at full rates.

In my opinion, the administration's retreat to a capital gains exclusion causes difficulties in three areas. First, it perpetuates a number of technical problems with the current exclusion. Second, it causes an undesirable distributional outcome for the package as a whole. And third, it buys very little in terms of additional capital formation.

PROBLEMS WITH THE CAPITAL GAINS EXCLUSION

It is important to understand at the outset that capital gains taxation is necessarily a rough justice compromise between the investor and the exchequer. Given our fundamental choice to tax income, ideal taxation of capital gains is unattainable. The problem is that we must tax capital gains when they are realized (that is, when the capital asset is sold), rather than on accrual (that is, as the asset changes in value, year by year). Many difficulties of capital gains taxation would be avoided if we could tax the increase (or decrease) in value of every asset every year, whether the asset were sold or not.

Accrual taxation is unattainable for a number of reasons. One is the impossibility of determining the changes in the values of some assets that are not sold (values of investment antiques or real estate are not quoted on national exchanges as are those of stocks and bonds). Another is that investors holding much of their wealth in the form of indivisible assets (such as businesses or some real estate) could have liquidity problems if they had to pay capital gains tax on the appreciation of their assets but had little cash income from which to pay it. And a final reason is that both the federal government and investors would have to accommodate wide swings in tax liabilities as changes in business conditions sent asset values up and down.

Failing accrual taxation, we must tax capital gains as they are realized. This causes some serious difficulties, all of which arise because gains are taxed only when the taxpayer chooses. The first major problem is the distorting effect of inflation on measured capital gains, and hence, on tax liabilities. If an asset increases in value by 10 percent over a period in which the price level increases at the same rate, the investor has no real gain. But under the current tax law, the investor must pay tax on 40 percent of his nominal gain, and thus pays a tax even though he has no real income.

If we taxed on accrual, inflation adjustments could be carried out on all assets at the same inflation rate every year, and thus would be quite simple. Taxation on realization means that each asset that is sold would have to be indexed according to inflation over its own precise holding period, and so indexation would be much more complex. This complexity is surely part of the reason why we have not indexed capital gains. (Another reason is probably that until the last ten years inflation was comparatively modest and uniform, and so the simple exclusion seemed a more acceptable approximation than it does now.) The extra burden on some capital gains due to inflation is often cited by advocates of more lenient capital gains taxation.

A second problem in capital gains taxation on realization is called bunching. When a taxpayer realizes a large capital gain that has accumulated over a long period of time, the entire gain is taxed in a single year. That large gain might push the taxpayer up through several tax rate brackets, imposing a larger tax than would be due if the gain were taxed in smaller installments over all the years when the gain was accumulating. Like the inflation problem, the bunching problem tends to increase tax liabilities relative to what might be due under a tax system closer to the ideal. The bunching problem has received little attention of late, in part because the general income averaging provision of the current law helps to cushion the problem, and in part because all tax reform packages extant would reduce the range of tax rates so much that the extra burden on a bunched gain would be significantly smaller.

As was mentioned at the outset, however, capital gains taxation is a rough justice compromise. Though our system gives investors some disadvantages, it gives them advantages as well. One important advantage arises directly from taxation only upon realization. The investors can choose if and when he will realize a gain and pay tax. If he has a large, diversified portfolio, he can realize losses to offset any gains he chooses to cash in, and thus can avoid tax. Further, by holding on to an appreciated asset, he can postpone taxation indefinitely. Such accrued and untaxed gains implicitly compound themselves tax free over time. This is the classic problem of deferral of tax, which is equivalent to an interest-free loan to the taxpayer from the government. For this reason, there is a significant advantage to investments that throw off their income in the form of capital gains rather than dividends or interest, which are taxed currently.

A final advantage of investors is the specific provision of the tax law that allows inheritors of appreciated assets to take as their tax basis the value of the asset at the time of bequest. Thus, if an investor buys stock for $100, the stock appreciates to $1000, and the investor dies and leaves it to his heirs, the heirs can sell the stock for $1000 with no taxable capital gain. Because the investor himself never pays capital gains tax, the capital gain is never taxed at all. This provision is called the "step up of basis" of inherited property, or sometimes, less technically, the "death escape."

Another problem with our current tax treatment of capital

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gains is its inevitable implications for capital losses. For one thing, because we allow taxpayers to exclude part of their capital gains, we must also exclude part of their capital losses, to prevent tax-advantaged sales of matching gains and losses. Further, because taxpayers with large diversified portfolios could choose to realize only their losses while holding their gains, thereby offsetting all income from other sources and paying no tax, we must restrict the amount of capital loss that may be offset against ordinary income (currently $3000 per year). Both of these restrictions on the deductibility of losses are assumed by economists to reduce risk-taking.

This combination of tax law provisions makes up the rough justice compromise of capital gains taxation. The administration's tax proposal does not deal directly with any of these problems. Though Treasury I proposed to index capital gains precisely for inflation, and thus address at least one issue, the administration backed away and restored the exclusion. As was noted above, the percentage exclusion is a most imprecise solution for the inflation problem. While the administration did cut the exclusion from 60 to 50 percent, thereby reducing the relative advantage of capital gains compared to ordinary income, the reduction of statutory rates leaves the maximum rate on capital gains lower than it is under current law.

It is interesting to consider the reaction of much of the investment community to Treasury I. Though investors have often argued for preferential treatment for capital gains on the ground of inflation, they protested when a precise remedy for the problem was offered. It is also important to keep in mind that inflation is not the only technical problem afflicting capital gains taxation, and that the other problems work to the advantage of the taxpayer. Deferral and the death escape are seldom mentioned by lobbyists for more lenient capital gains taxation.

One problem with the capital gains exclusion in the current law that the administration did address, at least in part, is tax-shelter conversion of ordinary income into capital gain. Many real estate tax shelters involve the depreciation of buildings using the straightline method over the short lifetime permitted by law. They then sell the property at capital gains rates without recapture of the early depreciation that was offset against ordinary rates. This tax avoidance technique is cut off by the administration proposal, which requires that capital gains on depreciable assets be taxed at ordinary rates after an inflation adjustment. While this part of the plan is admirable, one can only wonder why all capital gains were not restricted to this inflation-adjusted method, and whether the singling out of depreciable assets will not trigger requests to extend the exclusion to all assets.

DISTRIBUTIONAL EFFECTS OF THE ADMINISTRATION'S PLAN

One of the most controversial aspects of the administration's plan has been its substantial tax cut for upper-income households. The household sector receives an overall tax cut of about 7 percent, but those with incomes over $200,000 receive a 10.7 percent tax reduction; those in the range from about $30,000 to $100,000 receive tax cuts significantly below the average. This pattern is considered by some to be unfair.

Treasury I, in contrast, gave the highest-income taxpayers tax cuts that were quite close to the household-sector average. The cause of the swing between Treasury I and the administration plan is almost exclusively the change in the tax treatment of capital gains. (Concessions to independent oil and gas producers contribute somewhat.)

As was noted earlier, the capital gains exclusion is relatively more generous to people with large gains than would be the indexation in Treasury I. Further, taxpayers with very large incomes receive significant shares of their incomes in the form of large capital gains. Taxpayers with adjusted gross incomes of over $200,000 in 1982 received 38.2 percent of their income in the form of tax-favored long-term capital gains. Those with incomes over $1 million received 58.5 percent of their income as capital gains. Thus, the effect of the administration's concession on capital gains is perfectly predictable. And if the distributional pattern of the administration's plan is to be altered, it is worth remembering that a higher tax rate bracket will increase taxes most for those with ordinary income taxed at full rates.

ECONOMIC EFFECTS OF CAPITAL GAINS TAXATION

The administration's concessions to capital gains may be made in hopes of improved capital formation and economic growth. If so, the basis for these concessions is slim indeed.

Very little of our capital investment, year by year, comes from purchases of corporate equities by taxpayers who are subject to capital gains taxation. The great bulk of investment funds comes from corporate retained earnings and purchases of stock by tax-exempt entities such as pension funds and endowments of nontaxable institutions. Thus, capital gains taxation has little direct influence, and the historical record tends to bear this out.

Some might argue that concessions for capital gains lead corporations to retain more earnings, so that they can make their shares appreciate and yield capital gains to their investors; and that this is a cause of greater investment. If so, it is a mixed blessing. Most economists agree that the bias toward retained earnings prevents investment funds from being allocated among firms by the free market, and that this distortion leads to inefficiency and slower growth in the long run. It was this tendency that was at the root of the administration's proposed dividends-paid deduction; but of course, this deduction was greatly cut back between Treasury I and the administration plan.

Another argument for the capital gains preference is that it is a strong incentive for investment in new ventures. This argument is based in part upon claims that venture capital investments track changes in capital gains taxation quite closely, with booming investment when capital gains taxes are cut. This argument is weak. New venture investments were down in the early 1970s, after the increase in capital gains taxes in the Tax Reform Act of 1969, but the economy in general was in turmoil over that period. Venture capital investments picked up after the capital gains tax cut in 1978, but much of the increase in venture capital investments came from institutions that are nontaxable, including pension funds. It has been argued that the liberalization of portfolio restrictions on pension funds in ERISA, at about the same time, was more responsible for the boom in venture capital investments than was the capital gains tax cut. The alleged role of capital gains taxation in venture capital investments might also seem exaggerated in light of the shake-out among new ventures over the last two years, while tax treatment of capital gains did not change.

Another factor in the historical record is the development of new technologies. It is reasonable to argue that the genesis of microelectronics in the mid- and late-1970s caused the boom in venture capital investments, rather than the other way around.

Economists might argue that the venture capital industry, which is risky, would benefit significantly from a liberalized tax treatment of capital losses. Anecdotally, however, venture capitalists seem to reject this approach, saying that they expect to reap capital gains and want more generous treatment of them. They point to the records of some venture capital funds that have averaged rates of return in excess of 20 percent. While this approach may strike different people in different ways, one might ask why investments with average returns exceeding 20 percent need any special treatment from the tax system.

Other aspects of the administration's plan are already highly favorable to venture capital. Because new ventures tend not to benefit from other preferences in the tax code, they tend to have substantial taxable income and tax liabilities when they turn the corner to success. Thus, they would benefit disproportionately from the reductions in corporate (for corporations) and individual (for sole proprietorships and partnerships) statutory tax rates.

In any event, cutting taxes on capital gains is a most inefficient approach to aiding venture capital. The revenue costs of capital gains tax cuts for all other investments are extremely large relative to the size of the venture capital industry.

CONCLUSION

If the current tax treatment of capital gains is an uneasy compromise, the administration's proposal is more awkward still. While we must give credit for cutting off the capital gains exclusion for investments in depreciable assets, we might wonder why the administration did not stick to its original approach of full taxation of inflation-adjusted gains. The benefits of this retreat are quite small, and the costs, especially in terms of the unbalanced distributional effect of the plan, are appreciable.

THE EFFECTS OF TAXATION ON THE SELLING OF CORPORATE STOCK AND THE REALIZATION OF CAPITAL GAINS: COMMENT*

JOSEPH J. MINARIK

In a recent article in this *Journal*, Martin S. Feldstein, Joel Slemrod, and Shlomo Yitzhaki [FSY] find that marginal tax rates have a powerful effect on the realization of long-term capital gains on corporate stock, and project that a tax cut similar to that enacted in 1978 should triple realizations and increase tax revenues. This comment finds that an econometric error caused FSY to overstate the elasticity of realizations to tax rates by a factor of 51. Corrected and refined estimates show that tax rate cuts will not increase realizations sufficiently to increase tax revenues.

INTRODUCTION

In their article, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains," Martin S. Feldstein, Joel Slemrod, and Shlomo Yitzhaki [1980] provide a quantitative analysis of a vitally important subject. The continuing debate on capital gains tax policy has depended crucially on—but has been conducted in virtual ignorance of—the sensitivity of realizations to marginal tax rates.

Unfortunately, Feldstein, Slemrod, and Yitzhaki commit a basic econometric error that causes them to overstate the tax rate elasticity of capital gains realizations by a factor of 51. As will be demonstrated below, the correction of this error shows that reductions in capital gains tax rates would stimulate realizations far less than has been claimed and would reduce rather than increase tax revenues.

The first section of this comment briefly recaps Feldstein, Slemrod, and Yitzhaki's methodology and findings. The second section explains their econometric error and how it can be corrected. The third section provides alternative econometric estimates and a sim-

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ulation of the revenue effect of the capital gains tax cut of the Revenue Act of 1978. A brief conclusion follows.

ESTIMATES OF THE EFFECTS OF TAXATION

Feldstein, Slemrod, and Yitzhaki (hereafter FSY) used the U. S. Treasury's 1973 Capital Assets File (a stratified sample of tax returns with realized capital gains) in conjunction with the 1973 Individual Tax Model File (a stratified sample of all tax returns) to estimate the effects of marginal tax rates on the realization of long-term capital gains on corporate stock. They fitted a number of regression equations, and found no tax rate effect for the entire population of shareholders (identified through the receipts of dividends). However, when the sample was truncated to those shareholders with at least $3,000 of dividends (which translates, through the 1973 average dividend yield of 3.06 percent, to a portfolio of about $100,000 of corporate stock), a very strong tax rate effect emerged. Their key equation is presented as equation (1) in Table I. The age dummy variable takes the value of 1 if the extra exemption for taxpayers at least 65 years old is claimed on the return. The natural logarithms of adjusted gross income (*AGI*) and dividends are also included as independent variables. *TAXFSY* is an approximation of the taxpayer's actual last dollar tax rate on long-term capital gains (that is, the additional tax that would be due if the taxpayer realized one additional dollar of long-term gains) estimated through an instrumental variables technique, using the taxpayer's first dollar (that is, the additional tax due on the first dollar of realized long-term gains) and predicted last dollar (based on an average amount of capital gain for the taxpayer's income and dividend class) capital gains tax rates as instruments. The first-stage equation is not reported. No statistics on the goodness of fit of the main equation are reported.

The equation shows a sizeable effect of tax rates on realizations. The coefficient of the tax variable indicates that a ten-percentage point cut in the capital gains tax rate would increase the ratio of gains to dividends by 4.97. Using this result, FSY claim that capital gains tax cuts would generate so much additional trading and realization of gains that they would increase tax revenues. A simulation based on their estimated coefficient indicates that reducing the highest marginal tax rate on capital gains in 1973 to 25 percent would have tripled realizations.

Endogenous Sampling

The 1973 Capital Assets File, which FSY used in their study, is based on a stratified sample of tax returns for income year 1973. The sample was chosen on the basis of *AGI*, with a significant variation in sampling rates ranging from 100 percent for returns with *AGI* either negative or greater than $200,000, to 1 in 10,000 for the more prosaic returns with *AGI* positive but less than $10,000. Apart from negative income returns, sampling rates rise sharply and monotonically as *AGI* increases. Weights equal to the inverse of the sampling rates are provided on the file.

The elasticity of realizations to the marginal tax rate, calculated at the point of means from the summary statistics reported by FSY, is −3.75.[1] However, independent tabulations of the same data file show that those summary statistics are unweighted. An elasticity based on weighted statistics would be far more appropriate, especially considering that FSY use their coefficients for a simulation of the revenue effects of changes in capital gains tax rates using the weighted data file. Using tabulations of the weighted file, the FSY coefficients yield an estimated elasticity at the point of means of the population with portfolios of $100,000 and over, as opposed to the stratified sample of the same group, of −22.57![2]

The average tax return with at least $50,000 in dividends (or a portfolio of at least $1,500,000 of corporate stock) has a last dollar tax rate on capital gains of 20.6 percent and a ratio of long-term stock gains to dividends of 0.265. Thus, if FSY's result is correct, an increase in the marginal tax rate on gains of only 0.6 percent, from 20.6 to 21.2 percent, would be enough to cause the average shareholder with at least $1,500,000 of stock to stop realizing gains completely![3] Alternatively, a tax cut of only 0.6 percent would more than double his realizations! This truly remarkable result begs for examination.

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[1] Based on FSY's reported mean gains-dividends ratio of 3.50, the mean last dollar tax rate of 26.4, and the tax coefficient of −0.497. FSY's standard error for the −0.497 coefficient is −0.038, allowing for a two-standard-deviation range of elasticities from −3.18 to −4.32.

[2] Based on the weighted mean gains-dividends ratio of 0.295, the weighted mean last dollar tax rate of 13.39, and FSY's −0.497 tax coefficient. The range of elasticity estimates using two standard errors of the coefficient is from −19.11 to −26.01.

[3] The change in the tax rate, 0.6 percent, times the tax rate coefficient, −0.497, reduces the gains-dividends ratio by 0.2982, to a value less than zero. The two-standard-error range of tax changes necessary to stop realizations is 0.46 percent to 0.63 percent. The open-ended high dividend class was chosen for this example because it realizes the most gains in absolute terms. However, this class has a gains-dividends ratio only 0.03 less than the average of all returns with dividends of at least $3,000 (0.265 compared to 0.295), and so the computation noted above is quite representative of FSY's estimated sensitivity for all taxpayers.

FSY fit their equations using unweighted ordinary least squares. This method is correct in the conventional setting in which a sample is stratified according to an independent variable in a regression, as is illustrated impressionistically in Figure I. In this case, sampling rates (and thus the frequency of sampled, circled points in the graph) vary systematically as the tax rate changes. (It is immaterial, from an econometric point of view, whether the sampling rates increase or decrease as the tax rate increases.) An unweighted least squares line fitted through the sampled and circled points is an unbiased estimate of the relationship for the entire population. However, FSY neglect to consider that their sample is stratified according to the dependent variable, not the independent variable, as is shown impressionistically in Figure II. All else equal, tax returns with larger capital gains, and thus a greater *AGI*, are more likely to appear in the sample.[4] In the general case of stratification on the dependent variable, the direction of the bias on the estimate of the slope is indeterminate. In this case, as Figure II suggests, a negative relationship between the tax rates and realized capital gains would be systematically overstated. Using weighted least squares rather than ordinary least squares would eliminate the bias, and that is the method used in this comment.[5]

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[4] In fact, this understates the case. An unknown number of tax returns were sampled at even higher rates than would be justified on the basis of *AGI* alone because they had capital gains greater than *AGI* (due to the presence of business losses). A brief tabulation of sampling rates by long-term stock gain or loss (based on 1973 returns) will show that Figure II, simple as it is, accurately represents the problem with FSY's analysis:

Long-term stock gain or loss class	Average sampling rate
Loss or $0	1 in 86.5
1–2,500	1 in 140.1
2,500–5,000	1 in 106.2
5,000–10,000	1 in 64.6
10,000–20,000	1 in 51.0
20,000–30,000	1 in 35.4
30,000–50,000	1 in 18.7
50,000–100,000	1 in 12.3
100,000–200,000	1 in 6.2
200,000–500,000	1 in 2.4
500,000–1,000,000	1 in 1.5
1,000,000 and over	1 in 1.0
ALL	1 in 72.6

[5] See Appendix I.

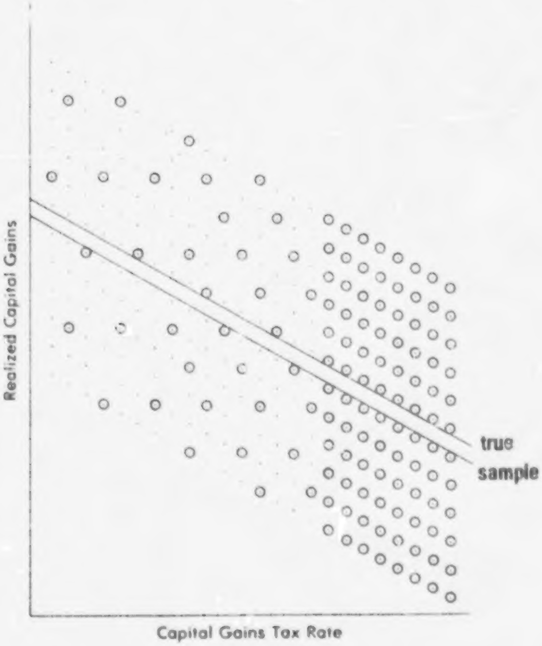

FIGURE I
Sampling Stratified by Tax Rate
(sampled points are circled)

ALTERNATIVE ESTIMATES

Tables I and II show the effects of a number of changes in the FSY regression analysis made in a step-by-step fashion. The results demonstrate that changing from ordinary to weighted least squares, as was shown to be necessary by the analysis above, yields much smaller estimates of the elasticity of capital gains realizations to tax rates.

The population in all of the equations, like that in FSY, is all tax returns with dividends greater than $3,000, and thus (at average 1973 yields) with portfolios of at least $100,000 worth of corporate stock. The dependent variable, again as in FSY, is the ratio of stock gains to dividends.

Equation (2) in Table I is my replication of the FSY equation

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TABLE I

UNWEIGHTED REGRESSION RESULTS ON REALIZATIONS OF LONG-TERM STOCK GAINS, 1973

Independent variables	Dependent variables: long-term stock gains[a] (equation numbers) (1)	(2)	(3)	(4)
Constant	35.0 (26.316)	27.530 (12.192)	30.169 (24.434)	N.A.
Age dummy	0.176 (0.499)	0.345 (1.008)	0.355 (1.041)	N.A.
Log (*AGI*)[b]	−0.504 (4.308)	−0.006 (0.064)	−0.796 (10.744)	N.A.
Log (Dividends)	−1.23 (10.336)	−1.626 (14.618)	−1.229 (10.849)	N.A.
TAXFSY[c]	−0.497 (13.113)	−0.342 (20.333)	N.A.	N.A.
TAXM[c]	N.A.	N.A.	−0.246 (17.018)	N.A.
Constant[a]	N.A.	N.A.	N.A.	81.110 (20.887)
Age dummy[a]	N.A.	N.A.	N.A.	5.108 (1.635)
Dividends[a]	N.A.	N.A.	N.A.	4.057 (8.770)
Dividends^2[a]	N.A.	N.A.	N.A.	−0.001 (1.609)
Adjusted gross income[a, c]	N.A.	N.A.	N.A.	−0.024 (3.402)
Adjusted gross income^2[a, c]	N.A.	N.A.	N.A.	−1.252 (10^{-6}) (2.472)
TAXM times dividends[a, c]	N.A.	N.A.	N.A.	−0.123 (6.816)
TAXM times *AGI*[a, c, d]	N.A.	N.A.	N.A.	1.460 (10^{-4}) (0.426)
Summary Statistics:				
Corrected R^2	N.R.	0.021	0.029	0.036
Corrected standard error	N.R.	27.262	27.149	27.056
Elasticity at point of means	−22.57	−15.53	−11.35	−16.83
Elasticity for \$3,000 ≤ dividends < \$10,000	−19.05	−13.11	−9.49	−26.85
Elasticity for \$10,000 ≤ dividends < \$20,000	−31.89	−21.94	−16.14	−19.46

TABLE I (*continued*)

Independent variables	Dependent variables: long-term stock gains^a (equation numbers)			
	(1)	(2)	(3)	(4)
Elasticity for \$20,000 ≤ dividends < \$50,000	−32.38	−22.28	−16.58	−11.81
Elasticity for dividends ≥ \$50,000	−38.63	−26.58	−20.05	−12.03

Sources. Equation (1), Feldstein, Slemrod, and Yitzhaki [1980]. Others, Internal Revenue Service 1973 Capital Assets File.

a. Divided by dividends.
b. *AGI* net of actual long-term and short-term stock gains plus predicted long-term gains.
c. Tax rates in regressions expressed as an integer number of percentage points.
d. *AGI* net of actual long-term stock gains.
N.A. = Not applied.
N.R. = Not reported.
t-statistics in parentheses.

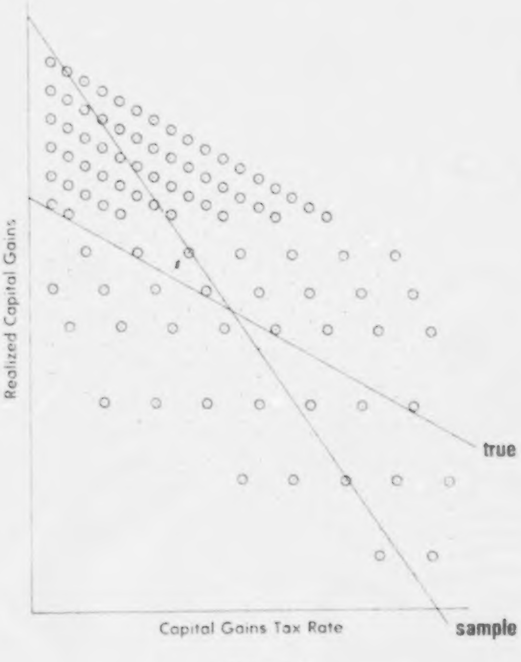

FIGURE II
Sampling Stratified by Income
(sampled points are circled)

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TABLE II

WEIGHTED REGRESSION RESULTS ON REALIZATIONS OF LONG-TERM STOCK GAINS, 1973

Independent variables	Dependent variables: long-term stock gains[a] (equation numbers) (1)	(2)	(3)
Constant	−0.955 (2.157)	1.196 (3.003)	N.A.
Age dummy	−0.303 (4.999)	−0.323 (5.290)	N.A.
Log(*AGI*)[b]	0.048 (4.278)	−0.165 (4.723)	N.A.
Log(Dividends)	0.097 (2.425)	0.136 (3.290)	N.A.
TAXFSY[c]	−0.039 (9.099)	N.A.	N.A.
TAXM[c]	N.A.	−0.022 (5.040)	N.A.
Constant[a]	N.A.	N.A.	2.925 (4.259)
Age dummy[a]	N.A.	N.A.	−1.231 (3.686)
Dividends[a]	N.A.	N.A.	0.512 (4.157)
Dividends^2 [a]	N.A.	N.A.	3.865 (10^{-4}) 0.550
Adjusted gross income[a, d]	N.A.	N.A.	0.009 (1.184)
Adjusted gross income^2 [a, d]	N.A.	N.A.	8.561 (10^{-7}) (1.470)
TAXM[a, c]	N.A.	N.A.	−0.525 8.284
TAXM^2 [a, c]	N.A.	N.A.	0.029 (12.664)
TAXM times dividends[a, c]	N.A.	N.A.	−0.016 (2.352)
TAXM times *AGI*[a, c]	N.A.	N.A.	−0.005 (14.452)
Summary Statistics:			
Corrected R^2	0.003	0.004	0.017
Corrected standard error	5.100	5.099	5.065
Elasticity at point of means	−1.77	−1.01	−0.44
Elasticity for \$3,000 ≤ dividends < \$10,000	−1.49	−0.85	−0.21
Elasticity for \$10,000 ≤ dividends < \$20,000	−2.50	−1.44	−0.31

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TABLE II (*continued*)

Independent variables	Dependent variables: long-term stock gains[a] (equation numbers) (1)	(2)	(3)
Elasticity for $20,000 ≤ dividends < $50,000	−2.54	−1.48	−0.42
Elasticity for dividends ≥ $50,000	−3.03	−1.79	−1.49

Sources. Internal Revenue Service 1973 Capital Assets File.
a. Divided by dividends.
b. *AGI* net of actual long-term and short-term stock gains plus predicted long-term and short-term gains.
c. Tax rates in regression expressed as an integer number of percentage points.
d. *AGI* net of actual long-term stock gains.
N.A. = Not applied.
t-statistics in parentheses

(presented as equation (1) in the same table).[6] The results of the two equations are different in some respects due to differences between the data files used by FSY and myself. FSY used the Internal Revenue Service's first version of the data file; my file is a second version, with some errors corrected. While my estimated elasticity of capital gains realizations to tax rates is numerically smaller (in absolute value) than that of FSY at −15.53, both estimates can be fairly described as astronomical, and the differences between the data files are probably sufficient to explain the modest shrinkage.

In equation (3) of Table I, the tax rate variable is changed to a preferred formulation that is computed directly rather than through the instrumental variables technique. This direct formulation, like the instrumental variables approach, avoids simultaneity between an individual taxpayer's marginal tax rate and the amount of gains he realizes; but unlike the instrumental variables approach, it circumvents some potential measurement problems due to current

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[6] The first-stage equation is (*t*-statistics in parentheses):

$$\begin{aligned} TAXFSY = {} & \underset{(10.221)}{8.566} + \underset{(3.835)}{0.494}\ \text{Age Dummy} \\ & - \underset{(3.709)}{0.121}\ \log(AGI) + \underset{(5.011)}{0.210}\ \log(\text{Dividends}) \\ & + \underset{(157.659)}{0.687 TAXF} - \underset{(3.305)}{0.004 TAXL} \end{aligned}$$

$$\bar{R}^2 = 0.460;\ C.S.E.E. = 10.270,$$

where *TAXF* is the actual first dollar tax rate and *TAXL* is the last dollar tax rate based on a predicted amount of gain.

transactions in assets other than corporate stock, or to loss carry-overs.[7] Changing from the FSY technique to the preferred formulation of the tax variable reduces the absolute value of the tax rate coefficient very slightly, with the measured elasticity also modestly lower at −11.35.

The specification of the original FSY equation and the present equations (2) and (3) is quite restrictive. A more general formulation would allow for interactions among the tax, dividend, and *AGI* variables, and would allow for a nonlinear tax response. Equation (4) in Table I so generalizes the relationship.[8] As can be seen from Table I, this preferred generalization of the specification raises the estimated elasticity to −16.83 when using ordinary least squares estimation. Thus, all of the preferred changes in the FSY specification cause minimal reductions or increases in the absolute value of the FSY elasticity when estimation is done by ordinary least squares.

Table II duplicates Table I with the sole exception that weighted least squares estimation is used. The results are substantially changed in all of the alternative specifications. The FSY formulation yields an average elasticity of −1.77, about one-ninth of my estimate using the same formulation with ordinary least squares, and about one-thirteenth of the FSY published result (computed with weighted summary statistics rather than the unweighted statistics presented by FSY).[9] The range of estimated elasticities extends from −1.49 in the smallest portfolio class to −3.03 for those with at least $50,000 of dividends. Shifting to the preferred tax rate variable in equation (2) reduces the elasticity to an average of −1.01,

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[7] See Appendix II.

[8] All variables in equation (4), rather than only the dependent variable as in equations (1) through (3), are divided by dividends; thus the constant term becomes 1/Dividends, the Dividends term becomes a constant, and Dividends^2 becomes Dividends. This normalization on both sides of the equation is a correction for heteroskedasticity. Absent the normalization, the estimated tax rate elasticities in the unbiased weighted version increase with portfolio size until for those with the largest portfolios they are counterintuitively positive.

[9] The first stage equation is (*t*-statistics in parentheses):

$$\begin{aligned} TAXFSY = {} & \underset{(11.263)}{-4.836} - \underset{(8.151)}{0.481}\ \text{Age Dummy} \\ & + \underset{(10.994)}{0.119}\log(AGI) + \underset{(14.748)}{0.567}\log(\text{Dividends}) \\ & + \underset{(237.147)}{0.823TAXF} - \underset{(1.493)}{0.001TAXL} \\ & \bar{R}^2 = 0.699;\ C.S.E.E. = 4.990, \end{aligned}$$

where *TAXF* is the actual first dollar tax rate and *TAXL* is the last dollar tax rate based on a predicted amount of gain.

with a range of −0.85 for the smallest portfolio class to −1.79 for the largest. The preferred specification is equation (3), which includes the nonlinearities and the interaction terms. In that equation the estimated average elasticity is −0.44, with a range from −0.21 (for those with $3,000 to $10,000 of dividends) to −1.49 (for those with over $50,000 of dividends).

The results from the preferred equation contrast sharply with those of FSY. The effect of dividends (as a proxy for portfolio size and net of the interaction with tax rates) on realizations is positive, as is that of income.[10] Both coefficients indicate that wealth and financial sophistication are associated with more frequent trading. The dummy variable for elderly taxpayers has a negative sign, indicating that the death escape from capital gains taxation overrides the need for cash among those at least 65 years old who own at least $100,000 worth of corporate stock.[11] All of these results are more plausible a priori than those of FSY. Unlike the FSY elasticity of −22.57, the average estimate here is plausible, and the pattern logically suggests that those with the largest potential tax liabilities are most sensitive to tax rates.[12]

Clearly, the much smaller estimated elasticity would have a drastic effect on any simulation of a change in the tax code regarding capital gains. Table III shows the effect (at 1973 income levels) of introducing the capital gains tax reductions in the Revenue Act of 1978.[13] The results show that the reductions in capital gains tax rates

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[10] *AGI* is measured net of stock gains. Inclusion of actual stock gains in the income variable would result in multicollinearity with any tax rate on gains. Inclusion of an average amount of stock gains, as in FSY, imparts a negative bias to the coefficient, because such a variable underestimates true *AGI* for high-gain returns and overestimates it for those with low gains. Omission of the insignificant squared term does not change the results.

[11] FSY argue that the elderly are more likely to sell stock to satisfy their need for cash, but are less likely to realize gains because the basis of their shares will be revalued at death and the capital gains tax avoided. This would suggest that FSY might obtain a negative coefficient for the dummy in the gains equation, but not in the sales equation (entirely consistent if the elderly with diversified portfolios, as most with at least $100,000 of stock probably have, follow the age-old, or perhaps old age, adage of "realize your losses and let your gains run"). In fact, FSY get precisely the opposite signs (though the gains equation coefficient is insignificant), suggesting again that their results are suspect. The dummy coefficients in Table II, in contrast, are plausible a priori.

[12] An expanded model, partially accounting for the transitory fluctuations in marginal tax rates on capital gains, suggests that a longer run elasticity might be somewhat smaller (in absolute value) for the most tax sensitive larger portfolio groups, with an overall average of about −0.79 [Minarik, 1981].

[13] The Revenue Act provisions include the reduction of the portion of long-term gains included in adjusted gross income from 50 to 40 percent, the abolition of the alternative tax, and the removal of the excluded portion of long-term gains from tax preferences in the minimum tax and the maximum tax.

TABLE III

CHANGES IN TAX LIABILITY RESULTING FROM THE CAPITAL GAINS TAX REDUCTIONS OF THE REVENUE ACT OF 1978, 1973 INCOME LEVELS

Adjusted gross income (dollars)	Number of returns[a] (thousands)	1973 tax liability (millions of dollars)	Tax liability under 1978 act (millions of dollars)	Change in tax liability (millions of dollars)	Change in tax liability (percent)	Change in tax liability (dollars per return)
Less than 0	15.1	11.6	1.9	−9.7	−83.9	−645.4
0–2,500	83.3	0.3	0.0	−0.3	−98.0	−3.6
2,500–5,000	98.8	9.5	8.6	−0.9	−9.1	−8.8
5,000–7,500	106.3	33.6	30.8	−2.8	−8.4	−26.5
7,500–10,000	119.8	85.1	83.7	−1.4	−1.7	−12.0
10,000–15,000	244.7	324.0	317.4	−6.6	−2.0	−27.1
15,000–20,000	310.6	666.6	652.4	−14.3	−2.1	−46.0
20,000–25,000	245.0	726.4	708.2	−18.1	−2.5	−74.0
25,000–30,000	171.4	666.6	657.6	−9.0	−1.4	−52.6
30,000–50,000	329.3	2,316.9	2,241.8	−75.2	−3.2	−228.2
50,000–100,000	171.6	2,748.6	2,647.2	−101.5	−3.7	−591.5
100,000–200,000	48.0	1,964.6	1,843.8	−120.8	−6.1	−2,518.8
200,000–500,000	11.6	1,239.7	1,101.5	−138.2	−11.1	−11,880.3
500,000–1,000,000	1.7	495.1	413.6	−81.5	−16.5	−48,030.0
1,000,000 and over	0.6	546.2	434.6	−111.6	−20.4	−181,501.1
Total or average	1,957.6	11,834.9	11,143.0	−691.9	−5.8	−353.4

Sources. Internal Revenue Service 1973 Sales of Capital Assets File and Individual Tax Model File.
[a] With dividends of at least $3,000.

would reduce tax revenues by approximately $700 million, and that the amount of tax reduction would increase in both absolute and percentage terms as income increases.

CONCLUSION

Because of a statistical problem, the estimate by Feldstein, Slemrod, and Yitzhaki of the revenue effect of changes in capital gains tax rates is wide of the mark. The 1973 Capital Assets File data indicate that reductions in capital gains tax rates do not generate enough additional realizations to offset the static revenue loss. Further, if the amount of realizations of gains is an indicator of efficient reallocation of financial resources, the efficiency gains of such tax cuts will be far lower than FSY indicated.

In the more than three years since this comment was originally submitted, several rounds of data on post-1978 capital gains realizations have been released. These data have been cited by several analysts to argue that the 1978 capital gains tax cut was or was not self-financing. It might be helpful to conclude this comment with an analysis of the recent data as they pertain to this question. There are no data specifically on corporate stock sales, however, and so the discussion must be generalized to all capital gains.

The increase in the capital gains exclusion from 50 to 60 percent became effective on November 1, 1978, reducing the highest tax rate on capital gains from 49.125 percent to 34.9 percent. Excluded capital gains were dropped from the base of the minimum tax and the offset against the preferential maximum tax rate, but only as of January 1, 1979. This further reduced the highest rate on capital gains to 28 percent, and probably led to the postponement of realization of some gains from 1978 to 1979. The excess of net long-term capital gains over net short-term capital losses realized by the same taxpayers (that is, the amount of long-term capital gain, before the exclusion, that is subject to federal income tax) increased from $48.6 billion in 1978 to $70.5 billion in 1979. Using the 1978 figure as a base (a step that is discussed below) and taking the tax cut to be 20 percent (the percentage decrease in the included portion; in fact the tax cut was greater for taxpayers subject to the minimum or maximum taxes, and less for those who lost the 25 percent alternative tax on the first $50,000 of gain) implies an elasticity of −2.25. This is somewhat greater in absolute value than the −0.44 estimated here, but substantially less than FSY's −22.57.

Several factors suggest that this roughly calculated elasticity of

−2.25 somewhat exaggerates the actual experience. The first is the inclusion in 1979 realizations of a single sale—the Belridge oil merger—on which the price of a 56 percent family-owned firm was $3.65 billion. Such a realization is clearly unlikely to be repeated, though it was almost certainly encouraged by the capital gains tax cut. The second is the likely postponement of some gains from 1978 to 1979 due to the nature of the law, thus reducing the base and increasing the observed effect. The third is the use of the 20 percent tax cut for the rough calculation, though it was in fact somewhat larger for some taxpayers (the minimum and maximum tax effects likely outweigh the alternative tax repeal).

A fourth factor that must be considered is the counterfactual question. The proper comparison for 1979 realizations is not really with those for 1978, but rather those that would have occurred in 1979 in the absence of the tax cut. Realized capital gains have increased even in periods with no favorable tax changes, driven by increases in corporate dividends and fixed investment, aggregate real economic growth, mere inflation, and any number of other factors. The general price level increased by 8.6 percent in 1979 (using the gross national product deflator), and prices on the New York Stock Exchange rose at the same rate (measured by the NYSE composite index); both of these factors would independently increase realizations. It would be misleading to assign causally all of the increase in realizations in 1979 to the tax cut, with no allowance for these independent forces.

A final factor is the temporary, as opposed to continuing, unlocking effect of the 1978 tax cut. Economic theory predicts that those owners of appreciated assets who were on the margin of realizing their gains under the prior law would decide to sell after a tax cut.[14] The issue in this discussion, however, is how much realizations would be increased after this transient rush of asset sales. A fair interpretation of FSY's results would be that the 1978 tax cuts would approximately triple the level of realizations that would have occurred without the tax cut in every later year, and that there would be an additional temporary increase in realizations for one or perhaps several years following the cut.[15] Thus, again, the 1979 data are not indicative of the long-term effect on realizations and tax revenues; they must be discounted for the transient unlocking predicted by economic theory before any permanent unlocking effect can be measured.

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[14] See Minarik [1981], footnote 28, page 256, and its references.

[15] This interpretation is Feldstein's: "I think the right way to interpret these estimates is not as a short-run unlocking, but as a permanent unlocking. After all, what we are studying is differences among taxpayers that continue from year to year. I think what we are estimating here is that there would continually be more turnover in the market, more realizing of gains, and less postponement than there is today. I think this is probably a slight overestimate of the permanent extra revenue that would be produced but a substantial underestimate of the immediate effect of unlocking" [1978, p. 334].

The 1980 income tax data confirm that the long-term effect of the tax cut is in fact smaller than the 1979 figures would suggest. Net long-term gains in excess of net short-term losses in 1980 were $69.9 billion, down from the 1979 level, even though the stock market was strong in 1980 (which almost invariably causes realizations to go up, the sole exception in recent years being 1980), and inflation proceeded at 9.3 percent. Thus, it seems likely that the sharp increase in realizations in 1979 was in large part the result of the temporary unlocking effect, and that realizations and tax revenues will be lower in later years than the 1979 data suggest. The effect of the tax cut was more in line with the estimates presented here, and the FSY estimates, by the same token, appear even more unreasonable.

To demonstrate this, discard the 1979 data because of the purely temporary effects and compare the 1980 data directly with 1978. Assuming as a very rough first approximation that realizations in any event would have kept up with inflation, the remainder of the realization growth that can be assigned to the capital gains tax cut implies an elasticity of −1.05, not the −2.25 apparent from the 1979 data. Alternatively, it could be assumed that capital gains realizations would have increased at the same rate as corporate stock prices (in every year save two in which stock prices have increased since 1960, realized capital gains have increased faster; one of the exceptions is 1980). Using this standard, the remaining increase in realizations to be explained by the 1978 tax cut yields an elasticity of −0.67. Any discounting of these elasticities for the excess of the actual tax cut over the 20 percent assumed in the calculation and the understatement of the 1978 base due to tax incentives for postponement of realizations to 1979 would push them still closer to the estimate in this Comment.

The 1980 data, unfortunately, mark the end of our experiment with the 1978 tax cut. Effective June 9, 1981 (as determined by the conference committee on the Economic Recovery Tax Act of 1981 on August 1 of that year), the maximum tax rate on long-term capital gains was further reduced from 28 to 20 percent. After this tax cut of almost 29 percent for the highest income taxpayers, and with the NYSE index up 8.7 percent and the GNP deflator increasing by 9.4 percent in 1981, the final IRS figures show net long-term capital gain in excess of net short-term capital loss increasing to only $77.1

billion, up just 10.3 percent from 1980 and 3.3 percent from 1979. Assuming that realizations would just have kept pace with prices since 1978 and completely ignoring the 1981 tax cut implies an elasticity of realizations to tax rates of -1.10; assuming that realizations would have increased along with the stock market yields an elasticity of -0.72.[16] Any realizations stimulated by the 1981 tax cut would make these figures overestimates of the true effect of the 1978 cut. Thus, it seems even clearer that the 1979 increase in realizations was largely caused by the temporary unlocking, and that the remaining permanent effect of the tax cut is far smaller than claimed by FSY.

APPENDIX I

Hausman and Wise [1981] algebraically derive the bias and show that weighted least squares yields consistent estimates as follows. (In fairness, it should be noted that the Hausman and Wise analysis of this problem was published after FSY.)

Consider the two-variable example in Figure II where the amount of the gain (Y) is a function of the tax rate (X). Assume that for the population the density function $f(Y|X)$ is normally distributed around mean $X\beta$ with variance of σ^2. For the sample and because of the stratified sampling (for simplicity, by two classes), $f(Y|X)$ will be an irregular function that can be described by the density function,

$$h(y) = \begin{cases} \dfrac{P_1 \cdot f(y)}{P_1 \cdot Pr[Y \le L] + P_2 \cdot Pr[Y > L]}, & \text{if } y \le L \\[2ex] \dfrac{P_2 \cdot f(y)}{P_1 \cdot Pr[Y \le L] + P_2 \cdot Pr[Y > L]}, & \text{if } y > L, \end{cases}$$

where P_1 and P_2 are the sampling rates for the two sampling stratification classes, Pr indicates probability, and $f(y)$ is the normal density function $N(X\beta, \sigma^2)$. Dividing through by P_1, so that $P_2/P_1 = P$, one can state this density function as

$$h(y) = \begin{cases} \dfrac{f(y)}{\int_{-\infty}^{L} f(y)\,dy + P \cdot \int_{L}^{\infty} f(y)\,dy}, & \text{if } y \le L \\[2ex] \dfrac{P \cdot f(y)}{\int_{-\infty}^{L} f(y)\,dy + P \cdot \int_{L}^{\infty} f(y)\,dy}, & \text{if } y > L. \end{cases}$$

Integrating over this density function yields

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[16] This estimate is virtually identical to my alternative [Minarik, 1981] cited in footnote 12 above.

$$E(Y|X) = X\beta - \sigma \frac{(1-P)\phi[(L_i - X_i\beta)/\sigma]}{(1-P)\Phi[(L_i - X_i\beta)/\sigma] + P},$$

where ϕ is the normal density function and Φ is the normal distribution function. Not surprisingly, given that ordinary least squares gives estimates for the sample rather than the population, the parameter β is measured with bias. Note that under random sampling (that is, $P_1 = P_2$ so that $P = 1$) the bias term becomes 0, so ordinary least squares is unbiased. Note also that if stratification in the example were by tax rates rather than capital gains, $E(Y|X)$ would be unaffected, and OLS would yield unbiased estimates. Measuring the parameter β for the population rather than the sample would require minimizing

$$S = \sum_{i=1}^{N} \left(\frac{1}{P_i}\right)(Yi - X_i\beta)^2,$$

where P_i is the relevant sample rate for the *i*th observation. This is the formulation of weighted least squares, which yields unbiased estimates. However, the standard errors of coefficients as usually computed are incorrect; computation of correct standard errors is extremely complex and is not attempted in this paper.

APPENDIX II

The choice of a tax rate variable that is representative of the marginal rate at which taxpayers made their realization decisions, yet not simultaneous with the amount of gains realized, is difficult. Actual last dollar tax rates are simultaneous and thus cannot be used. FSY use an instrumental variables technique wherein the first-stage equation predicts the last dollar tax rate on long-term gains, with the first dollar capital gains tax rate and a predicted last dollar capital gains tax rate (based on average capital gains of returns with approximately the same *AGI* and dividends) as instruments. This choice of instruments is inappropriate for two reasons. First, the last dollar tax rate is the relevant cost for the investor's decision whether or not to realize additional gains; it is not the cost of realizing the gains he in fact did realize. While the last dollar tax rate is thus typically too high, the first dollar tax rate is analogously typically too low. Second, all three tax rates in FSY's first-stage equation are actually computed on marginal amounts of gains equal to $100, and thus can be strongly misleading if there are small amounts of carryover or other capital losses present. For example, the tax on the first $100 of stock gain for a return with $1,100 of short-term loss carryover is zero; however, if the carryover were only $1,000, the gain would be taxed at the ordinary rate that could be as high as 70 percent. Neither of these measures is an accurate tax rate for a more reasonable amount of gain. Of the tax returns in the file with dividends of at least $50,000, 26.7 percent (weighted; 29.0 unweighted) had zero first dollar tax rates, and 24.3 percent (weighted; 23.4 percent unweighted) had zero last dollar tax rates.

This is in marked contrast to the 8.3 percent (weighted; 11.2 percent unweighted) who had zero marginal tax rates on ordinary income. Another potential pitfall, though less serious, would be a small increment of gain falling within the 25 percent alternative tax on the first $50,000 of gain that was in the law in 1973.

The variable used here is the effective rate on a predicted amount of stock gain (the average stock gain of all returns with similar amounts of dividends and adjusted gross income). This formulation avoids the simultaneity of actual realizations with the tax rate because the predicted amount of gain on which the tax rate is calculated is not directly related to the taxpayer's actual gains (see FSY [1980], p. 780). It also minimizes the distortion of the tax rate due to small amounts of carryover or losses, because the predicted gain is large enough to swamp typical amounts of loss or carryover. Thus, only 11.8 percent (weighted; 11.5 percent unweighted) of the tax returns with dividends of at least $50,000 had zero tax rates by this measure. Finally, because the predicted amount of gain is typical of similar tax returns, the effective tax rate on that amount of gain is more representative of the tax rate at which marginal decisions were actually made in 1973 (see FSY [1980], p. 781).

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JOSEPH J. MINARIK

Capital Gains

FEDERAL income tax treatment of capital gains is highly controversial. Long-standing equity and administrative issues continue to arouse heated debate: whether capital gains should be taxed at all; what preferential treatment, if any, gains should be given relative to ordinary income; to what extent net losses should be deducted from ordinary income; whether appreciated gifts and bequests should be taxed, or what basis they should carry to recipients; and many more. But perhaps because of the sluggish progress of the U.S. economy, the effect of capital gains taxation on economic growth and efficiency has claimed a great deal of attention. Economists and laymen argue about whether capital gains taxation reduces capital investment or distorts its allocation, thereby slowing the rate of growth of output and productivity. These questions were discussed during the congressional deliberations in 1978 that yielded significant reductions in the taxation of capital gains, and widely disseminated economic analyses of these issues may have had an important influence on the legislative outcome. The influence of capital gains taxation on the economy must be understood to evaluate the 1978 decision and to choose appropriate future policy; the purpose of this paper is to increase this understanding.

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Three Issues in Capital Gains Taxation

While numerous arguments have been raised for preferential treatment of long-term capital gains, this discussion will focus on three major issues: the bunching of long-term gains, the opportunities for timing the realization of gains and losses, and the lock-in effect of the tax on capital gains.

With progressive taxation of long-term gains upon realization, the included portion of a long-term gain is taxed at the taxpayer's highest marginal tax rate on ordinary income. If the gain is large relative to the taxpayer's typical ordinary income, it could fall into still higher marginal rate brackets and incur a tax liability significantly higher than if part of the gain were taxed each year during which the asset was held.[1] This bunching problem has been widely recognized in the general literature on capital gains taxation, though the data available have not permitted estimation of the frequency or the amount of overtaxation caused by bunching until quite recently.

Some experts have argued that bunching should be remedied through more exact methods than the present general exclusion of 60 percent of long-term gains. One possible solution would be to average capital gains and other income over the period the asset was held (or some maximum period longer than the five years available to any taxpayer under current law). Goode points out that income averaging would provide relief for a taxpayer whose taxable income (including the gain) was substantially larger than usual, but none if his income including capital gains was stable, however bunched an individual gain might be. Averaging would complicate the tax forms and require records from earlier years, but many transactions could be disqualified from averaging because they were too small relative to average total income for averaging to significantly affect the tax liability.[2]

An alternative to income averaging would be proration of capital gains over the number of years the asset was held or some maximum period. The portion representing appreciation in the current year would be taxed as usual; the remainder for previous years would be taxed at the same effective rate as that for the current year. The effect would be to moderate the rate progression applied to the gain; the share of the gain prorated to earlier years would not be allowed to reach into higher marginal rate brackets. David points out that proration, unlike averaging, would be based only on the current year's tax return and thus would require no record keeping beyond the asset's basis; also unlike averaging, proration would reduce the tax liability on a large gain held over several years even if taxable income, including gains, was stable. Goode argues that prorating more than a small number of gains would be unwieldy, and Wetzler contends that to adopt proration in addition to general income averaging would enormously complicate the tax code.[3]

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[1] For example, taxation in full of a $100,000 gain (held for two years) in 1978 would result in a liability of $24,180 for a single person claiming the standard deduction and having no other income. If the gain were split evenly between the two years, the total liability would be only $19,280. The problem is more serious the longer the holding period; it is nonexistent if the gain does not push the taxpayer into a higher marginal rate bracket.

[2] Richard Goode, *The Individual Income Tax*, rev. ed. (Brookings Institution, 1976), pp. 191–95.

The third way to solve the bunching problem is taxation of gains as they accrue rather than when they are realized. Accrual taxation would involve formidable problems, including the valuation of assets rarely sold, the inventorying of all assets with the filing of each return, and the payment of taxes on accrued gains that had not been realized in cash.[4]

Some experts contend that the bunching problem, while potentially serious under particular circumstances, is not worrisome in practice. They see bunching as the result of the taxpayer's privilege to defer the realization of the gain until a time of his choosing and thus defer taxation of the appreciation. Concessions such as averaging or proration would reduce the tax liability upon realization to approximately the sum of the liabilities that would have been due in each year if the gain had been taxed on accrual. This would give the taxpayer the advantage of the time value of money while the tax was deferred. Some experts argue that the deferral of taxes on capital appreciation is a significant benefit to recipients of capital gains and thus makes the need for other preferential treatment less urgent. Wetzler has proposed a deferral charge as compensation for the implicit interest-free loans from the federal government to holders of appreciating assets.[5]

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[3] Martin David, *Alternative Approaches to Capital Gains Taxation* (Brookings Institution, 1968), pp. 166–80; Goode, *Individual Income Tax*, p. 192; James W. Wetzler, "Capital Gains and Losses," in Joseph A. Pechman, ed., *Comprehensive Income Taxation* (Brookings Institution, 1977), pp. 130–32.

[4] David, *Alternative Approaches to Capital Gains Taxation*, pp. 183–85.

[5] Wetzler, "Capital Gains and Losses," pp. 115–53. See also Roger Brinner and Alicia Munnell, "Taxation of Capital Gains: Inflation and Other Problems," Federal Reserve Bank of Boston, *New England Economic Review* (September–October 1974), pp. 3–21.

A further issue is the taxpayer's opportunity to time the realization of gains and losses. Consider the owner of a diversified portfolio of securities who relies on their appreciation to meet his cash needs. If his assets on the average increase in value but some decline, he can sell a balanced group of appreciating and depreciating assets with a total net gain of zero and pay no tax. The rest of his appreciating assets can be left to grow in value and under current law can be contributed to charity or bequeathed with no capital gains tax. Further, the heirs will not be liable for capital gains tax on the appreciation that occurred before they inherited the property. Some experts argue that the potential for deferring the tax and timing the realization renders further preferences somewhat redundant, but others believe that taxpayers with small portfolios cannot diversify sufficiently to take advantage of this. Available data have not permitted detailed analysis of the offsetting of gains and losses.[6] It is known that in 1962, of 4.3 million returns reporting net capital gains, 0.7 million realized some losses; and of 1.5 million reporting net losses, 0.7 million realized some gains.[7]

Some experts argue that taxation of gains locks investors in to assets that do not offer the best available yield. The lock-in effect takes two forms. First, the requirement that assets be held for a minimum length of time before preferential treatment is granted inhibits the sale of assets held for less than that period. Seltzer found that the five graduated holding periods in the law from 1934 to 1937 significantly reduced the turnover of capital assets.[8] Fredland, Gray, and Sunley demonstrated that realizations in 1962 were significantly reduced just before, and significantly increased just after, securities were held for six months.[9]

A lock-in effect also occurs when the tax that would be due upon the sale of an appreciated asset absorbs the profit from selling that asset and purchasing another with a higher pretax yield.[10] Brannon examined time series data and found evidence of reduced realizations as the result of capital gains taxation, but precise estimates were impossible because of data limitations.[11] Auten used pooled annual aggregate data by income class and identified a lock-in effect.[12] Feldstein, Slemrod, and Yitzhaki contend that actual realizations are highly sensitive to reductions in taxes applicable to capital gains, and that tax cuts would thus encourage enough additional realizations to increase total tax revenue. Using 1973 tax returns, they estimated a very high elasticity of realizations to the applicable marginal tax rate and computed on that basis that reducing the maximum tax rate on long-term capital gains from 45.5 percent to 25 percent would increase revenue.[13] Auten and Clotfelter, using a panel of tax returns for the 1967–73 period, found a smaller response to taxpayers' average tax rates over time. They also found a response to fluctuations in the tax rates (caused by variations in deductions and other income) that was greater than the response to average tax rates in some specifications.[14] Some experts counter that the lock-in effect is not so much the result of an insufficient preference for capital gains realizations as of forgiving income tax on capital gains held until death or given to charity and postponing tax on appreciation of assets given to other individuals. They claim that eliminating those preferences would be the best way to reduce the lock-in effect.[15]

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[6] David, *Alternative Approaches to Capital Gains Taxation*, pp. 73–81.

[7] U.S. Treasury Department, Internal Revenue Service, *Statistics of Income—1962, Supplemental Report, Sales of Capital Assets Reported on Individual Income Tax Returns* (Government Printing Office, 1966), p. 60, table 6, and p. 86, table 9.

[8] Lawrence H. Seltzer, *The Nature and Tax Treatment of Capital Gains and Losses* (National Bureau of Economic Research, 1951), pp. 167–72.

[9] J. Eric Fredland, John A. Gray, and Emil M. Sunley, Jr., "The Six Month Holding Period for Capital Gains: An Empirical Analysis of Its Effect on the Timing of Gains," *National Tax Journal*, vol. 21 (December 1968), pp. 467–78.

[10] Suppose that an investor paid $500 for stock that is now worth $1,000, and that the stock yields 10 percent with no prospect of further capital gain. If the effective tax rate on the gain is 20 percent, the investor could not profitably switch to a

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new security unless it yielded over 11.1 percent. The disincentive to reallocate funds from the security yielding 10 percent to any other yielding between 10 and 11.1 percent is the lock-in effect. Charles C. Holt and John P. Shelton, "The Lock-In Effect of the Capital Gains Tax," *National Tax Journal*, vol. 15 (December 1962), pp. 337–52; Beryl W. Sprinkel and B. Kenneth West, "Effects of Capital Gains Taxes on Investment Decisions," *Journal of Business*, vol. 35 (April 1962), pp. 122–34.

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Bunching of Long-Term Gains

As mentioned earlier, the bunching of long-term gains in a single year under a progressive income tax can increase tax liabilities. On the other hand, taxation is deferred over the years in which the gains accrued, in effect constituting an interest-free loan of the tax liability on the accrued gain from the government to the asset holder. And taxpayers can choose the year in which they realize their gains to minimize their tax liability.

It is impossible to disentangle the relative effects of bunching and deferral with existing data. It is possible, however, to look at the bunching question and the timing of realization with the Internal Revenue Service Seven-Year Panel of Taxpayers, a random sample of identical filers' tax returns over the period 1967–73.[16]

The panel file shows only the total net gain or loss for any one year, and so it is impossible to gauge precisely the holding period over which any individual gain or loss item accrued. However, the file can show whether a net gain in one year is an isolated event or whether gains are realized in every year. It can also show whether the net gain in a particular year is taxed at a higher or lower marginal rate than is typical for the taxpayer over the duration of the panel. Because of the particular limitations and capabilities of the panel file, this analysis cannot compare the taxation of gains as they accrue, as opposed to lump sums when they are realized (that is, the type of bunching that is cited by advocates of proration). Rather, it will provide some indication of the frequency of realized gains that are large relative to average income over several prior and subsequent years (that is, the additional tax that would be prevented by a general capital gains averaging provision that corrected for losses as well as gains).

The bunching problem arises when a taxpayer realizes a long-term gain that is large relative to his average income.[17] Such a taxpayer would bear a far higher liability on that gain upon realization than he would under accrual taxation or a proration or averaging provision. In contrast, another taxpayer who is an active trader in capital assets may time his realizations along with his receipts of ordinary income and his itemized deductions, so that his income including capital gains is stable.[18] For such a taxpayer, mandatory averaging of capital gains over several years would increase rather than decrease total tax liabilities.

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[16] The file contains information on a uniform random sample of taxpayers; thus its coverage of upper income taxpayers with large amounts of capital gains is limited. The sample includes the returns of 21,382 taxpayers for at least one year each, but some of these did not file returns in all of the seven years. For this analysis the sample is limited to 3,430 taxpayers who filed returns in at least five of the seven years and realized capital gains or losses in at least one of the years in which they filed returns.

[17] The archetypical case is the sale of a business or partnership interest upon retirement

The relative frequency of realizations of "once in a lifetime" gains and of carefully timed recurrent gains should have an important influence on public policy. If highly bunched gains are common, policy should lean in the direction of protection from such extremes; but if many taxpayers already average by timing their gains, other income, and deductions appropriately, policies to ameliorate bunching are less urgent. This is especially true in light of the complexity of special provisions for taxpayers and tax authorities and the potential for abuse.[19]

To measure the extent of bunching, table 1 shows tax liabilities, by income class, for taxpayers in the panel file who realized long-term capital gains or losses in at least one year. Column 2 shows the average tax liability over the period with the 1973 tax law applied in each year and no income averaging permitted.[20] Column 3 shows the tax that would have been due under a complete income and deduction averaging system.[21] The difference between these columns is the additional tax that is due because of all fluctuations of income and deductions, including but not restricted to capital gains. For the entire population, this difference is about 9 percent of the tax liability without averaging. Column 4 is the total tax liability if capital gains, but no other income or deduction item, were averaged over the period.[22] For the entire population, averaging

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[18] The same effect obtains if a taxpayer, to maintain his consumption, realizes gains when his other income is low.

[19] For some tax experts, the deferral of tax liability would be a compelling argument against concessions to recipients of long-term capital gains regardless of the impact of bunching.

[20] A single tax law is used because taxpayers who plan their realizations to minimize their tax liability are likely to attempt to stabilize their taxable income, and because changes in tax laws are difficult to anticipate. From that point of view, use of different tax laws over the period would mask the taxpayer's behavior. Income averaging is omitted for the same reason.

[21] That is, the tax due on the average amount of ordinary income and the average amounts of net long-term and net short-term gain, less the average amounts of deductions and personal exemptions.

[22] That is, the average tax that would be due if tax were calculated in each year on the actual amounts of ordinary income, deductions, and exemptions, and the average amounts of net long-term and net short-term gain or loss over the period. This tax system is applied as an analytical device rather than a policy proposal.

Table 1. Average Annual Tax over a Five-to-Seven-Year Period for Taxpayers Who Realized Capital Gains

Dollars unless otherwise specified

Adjusted gross income net of capital gains	*Number of returns*[a] *(1)*	*Tax with actual income and deductions per return per year*[b] *(2)*	*Tax with averaged income and deductions per return per year (3)*	*Tax with averaged capital gains and actual other income and deductions per return per year (4)*	*Percentage of tax saving through complete averaging achieved by averaging of capital gains only (5)*
Less than 0	16	133	45	1,302	−1,328.7
0–1,000	27	91	17	143	−70.6
1,000–2,000	85	80	28	67	25.1
2,000–3,000	128	155	95	135	34.1
3,000–4,000	158	250	182	225	36.6
4,000–5,000	163	377	277	344	32.3
5,000–10,000	949	805	699	758	44.1
10,000–15,000	921	1,570	1,426	1,481	61.9
15,000–20,000	459	2,656	2,428	2,496	70.0
20,000–25,000	220	3,701	3,403	3,538	54.7
25,000–50,000	227	7,487	6,917	7,248	41.9
50,000 and over	77	33,408	30,943	31,256	87.3
Total or average	3,430	2.521	2,298	2,390	58.6

Source: Internal Revenue Service Seven-Year Panel of Taxpayers.

a. Includes returns of taxpayers who submitted tax returns for at least five of the seven years and realized capital gains in at least one of those years.

b. Under provisions of the 1973 law.

capital gains over the seven years would reduce tax liabilities by about 5 percent. Thus capital gains bunching accounts for approximately 59 percent of the additional taxation caused by the absence of a complete averaging system. This fraction generally increases with income net of gains; in fact, averaging of only gains over the period would increase taxes for the two lowest income classes as a whole.

This result suggests that some taxpayers, even those at higher income levels, may time their gains to coincide with years in which their ordinary income is below average and their deductions are higher than normal. This question is explored further in tables 2, 3, and 4, which show the effect of averaging capital gains only over the entire sample period for taxpayers whose tax would be increased by such averaging—12.5 percent of the population. As mentioned earlier, this occurs when taxpayers with

Table 2. Tax Returns with Taxes Increased by the Averaging of Capital Gains, by Income Other Than Capital Gains

Income other than capital gains (dollars)	*Total number of returns*	*Returns with taxes increased by capital gains averaging*		*Percentage increase in tax caused by capital gains averaging*
		Number	*Percent*	
Less than 0	16	8	50.0	6,192.1
0–1,000	27	5	18.5	199.4
1,000–2,000	85	18	21.2	47.0
2,000–3,000	128	26	20.3	32.8
3,000–4,000	158	38	24.1	21.9
4,000–5,000	163	37	22.7	28.0
5,000–10,000	949	125	13.2	22.3
10,000–15,000	921	63	6.8	17.6
15,000–20,000	459	37	8.1	8.3
20,000–25,000	220	26	11.8	7.8
25,000–50,000	227	40	17.6	8.3
50,000 and over	77	7	9.1	6.0
Total or average	3,430	430	12.5	13.2

Source: Same as table 1.

Table 3. Tax Returns with Taxes Increased by the Averaging of Capital Gains, by Number of Years Gains Were Realized

Number of years gains were realized	*Total number of returns*	*Returns with taxes increased by capital gains averaging*		*Percentage increase in tax caused by capital gains averaging*
		Number	*Percent*	
1	1,283	108	8.4	14.0
2	569	68	12.0	10.3
3, 4, or 5[a]	808	98	12.1	6.5
4, 5, or 6[b]	306	67	21.9	11.8
5, 6, or 7[c]	464	89	19.2	21.2
Total or average	3,430	430	12.5	13.2

Source: Same as table 1.

a. Three years for taxpayers with five tax returns in the sample; three or four years for those with six returns; and three, four, or five years for those with seven returns.

b. Four years for taxpayers with five tax returns in the sample; five years for those with six returns; and six years for those with seven returns.

c. Five years for taxpayers with five tax returns in the sample; six years for those with six returns; and seven years for those with seven returns.

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Table 4. Tax Returns with Taxes Increased by the Averaging of Capital Gains, by Amount of Capital Gains

Capital gains (dollars)	*Total number of returns*	*Returns with taxes increased by capital gains averaging*		*Percentage increase in tax caused by capital gains averaging*
		Number	*Percent*	
Less than 0	751	64	8.5	8.1
0–1,000	1,940	206	10.6	10.2
1,000–2,000	302	63	20.9	10.8
2,000–3,000	137	32	23.4	12.2
3,000–5,000	137	27	19.7	13.0
5,000–10,000	88	21	23.9	9.7
10,000–25,000	46	10	21.7	22.2
25,000 and over	29	7	24.1	32.8
Total or average	3,430	430	12.5	13.2

Source: Same as table 1.

fluctuating ordinary income realize capital gains in years of low ordinary income and thus stabilize their total income. Further, frequent traders are likely to time their realizations to coincide with years in which their tax rates are low—one in five taxpayers with gains in all years or all but one year would have their taxes increased by mandatory averaging of gains, as against one in eight for the population as a whole. The frequency of such tax increases is a U-shaped function of income other than gains, but an increasing function of total gains. Tax increases caused by the averaging of gains equal approximately 13 percent of liability based on actual gains.

The tendency to time realizations is evident in the data themselves. With the use of yearly percentage deviations ($\%DEV$) of adjusted gross income (net of all capital gains), itemized deductions (exclusive of state income and sales taxes), and net capital gains from the mean values for individual taxpayers for the duration of the panel, the following regression equation was obtained from the panel data (t-statistics are given in parentheses):

$$\%DEVGAIN = 1.3231 - \underset{(3.067)}{0.0601}\ \%DEVAGI + \underset{(13.189)}{0.4254}\ \%DEVDED.$$

$$R^2 = 0.0075;\ \text{standard error} = 200.321$$

The equation indicates that, if a taxpayer's adjusted gross income (AGI) in any one year is 1 percent higher than his mean adjusted gross income

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over the seven years of the panel, his net capital gains (*GAIN*) will be about 0.06 percent lower than his mean value. Further, if his itemized deductions (*DED*) are 1 percent higher than his mean deductions over the seven years, his net capital gains will be about 0.4 percent greater than his mean value. Both coefficients are consistent with the hypothesis that taxpayers tend to realize gains when their tax rates are temporarily reduced, although the deductions effect seems to be much more pronounced than the income effect.

These results suggest that many taxpayers do experience bunching of capital gains, as conventionally assumed, and incur higher tax liabilities as a result. The income averaging system now in the law reduces such excess liabilities. On the other hand, others time their gains and losses when their deductions are high and their other income is low in order to reduce their tax liabilities; those who realize the greatest gains and who realize them most frequently are the most likely to time their realizations. This benefit of the realization principle for capital gains recipients is often overlooked.

Timing of Capital Gains and Losses

Because the data used in the preceding analysis include only net short-term and net long-term capital gains or losses, it was not possible to measure the extent to which individual gain or loss transactions were used to offset each other. The 1973 Internal Revenue Service Sales of Capital Assets File provides detail on individual capital transactions and therefore can be used to analyze the timing of capital gains and losses during a single year.[23]

Table 5 summarizes the information on realized capital gains and losses in the 1973 file. Column 3 shows that 24 percent of all returns with net gain reported at least some losses, and that the frequency of realizing offsetting gains and losses increases sharply as income increases. The ratio

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[23] The Sales of Capital Assets File contains information on the approximately 50,000 tax returns from the IRS Individual Tax Model File (which contains a total of approximately 100,000 tax returns) that include capital transactions. Each transaction is detailed with the type of asset, the dates of acquisition and sale of the asset, and the cost basis and purchase price. The Sales of Capital Assets File shares the stratified sample design of the Individual Tax Model File, with 100 percent sampling of tax returns with adjusted gross income above $200,000. Thus the Capital Assets File includes a rich sample of tax returns with large and numerous capital asset transactions, but has also been stratified accurately to replicate the entire population.

Table 5. Capital Gains and Losses on Federal Income Tax Returns, 1973

Adjusted gross income net of capital gains (dollars)	*Number of returns with net gain* (*1*)	*Number of net gain returns with some losses* (*2*)	*Percent of net gain returns with some losses* (*3*)	*Gross gain divided by net gain* (*4*)	*Number of returns with net loss* (*5*)	*Number of net loss returns with some gains* (*6*)	*Percent of net loss returns with some gains* (*7*)	*Gross loss divided by net loss* (*8*)
None	121,979	21,404	17.6	1.3	25,449	5,932	23.3	1.9
0–2,500	308,969	58,866	19.1	1.5	101,570	53,021	52.2	1.4
2,500–5,000	299,363	56,719	19.0	1.6	119,672	19,120	16.0	1.4
5,000–7,500	284,160	34,464	12.1	1.5	124,637	23,742	19.1	1.5
7,500–10,000	311,023	74,756	24.0	1.4	125,035	39,535	31.6	3.5
10,000–15,000	536,069	95,290	17.8	1.6	283,754	85,199	30.0	1.5
15,000–20,000	423,784	100,355	23.7	1.6	343,242	113,548	33.1	1.8
20,000–25,000	269,874	78,082	28.9	1.5	254,347	83,984	33.0	1.4
25,000–30,000	194,498	59,809	30.8	1.5	159,861	80,267	50.2	1.6
30,000–50,000	312,968	122,800	39.2	1.7	265,850	104,771	39.4	1.9
50,000–100,000	142,776	66,690	46.7	1.7	116,732	60,895	52.2	2.0
100,000–200,000	33,481	17,714	52.9	1.5	23,655	14,904	63.0	2.1
200,000–500,000	6,898	4,059	58.8	1.4	4,063	2,836	69.8	1.9
500,000–1,000,000	721	436	60.5	1.3	382	301	78.8	2.2
1,000,000 and over	228	148	64.9	1.3	144	117	81.3	1.9
Total or average	3,246,791	791,592	24.4	1.5	1,948,393	688,172	35.3	1.8

Source: Internal Revenue Service Sales of Capital Assets File.

Table 6. Ratio of Stock Sales to Dividends for Returns with Net Stock Gains

Class of net stock gain (dollars)	*Number of returns*	*Stock sales divided by dividends*
0–2,500	718,576	2.5
2,500–5,000	163,942	4.9
5,000–7,500	76,615	4.7
7,500–10,000	32,224	7.9
10,000–15,000	57,787	4.1
15,000–20,000	19,327	4.5
20,000–25,000	19,779	8.3
25,000–30,000	11,063	6.0
30,000–50,000	21,123	7.1
50,000–100,000	15,721	7.8
100,000–200,000	8,387	17.3
200,000–500,000	3,658	13.4
500,000–1,000,000	1,066	12.9
1,000,000 and over	603	19.5
Total or average	1,149,871	6.6

Source: Same as table 5.

of gross gain to net gain decreases slightly with income. Columns 7 and 8 show similar results for net loss returns, but with the ratio of gross loss to net loss increasing with income.

A further aspect of the timing issue is the degree to which shareholders at various net gain or loss levels turn over their portfolios in any given year. Table 6 shows that the ratio of stock sales to dividends rises sharply as net stock gains increase. Moreover, returns with large net stock gains reported ratios of stock sales to dividends that are high relative to the ratio of the value of all stock outstanding to total dividend payments.[24] Thus for many investors with large portfolios, the potential for realization of larger amounts of capital gains in response to reduced tax rates on gains is limited.[25]

[24] The ratio of stock sales to dividends for returns with net stock gains of $1,000,000 or more was 19.5. Based on the average 1973 dividend yield of 0.0306 (*Economic Report of the President, 1979*, p. 285, table B-88), the ratio of total portfolio value to dividends averages 32.7.

[25] Simulations of the tax implications of unlocking accrued gains often rely on a proportional increase in realized gains based on changes in effective tax rates (such as Feldstein, Slemrod, and Yitzhaki, "Effects of Taxation"). On this basis, much of the simulated increase in realized gains (in absolute terms) comes from tax returns that already have large amounts of realized gains. Table 6 suggests that many of those returns may have limited additional gains to realize.

Table 7. Relationship of Stock and Nonstock Gains and Losses, Returns with Net Stock Gain, 1973

		Returns with nonstock net gain		*Returns with nonstock net loss*	
Adjusted gross income net of capital gains (dollars)	*Number of returns*	*Percent of all returns*	*Nonstock gain divided by stock gain*	*Percent of all returns*	*Nonstock loss divided by stock gain*
None	18,061	37.4	1.5	17.7	−0.2
0–2,500	89,444	3.3	0.8	21.4	−0.5
2,500–5,000	62,618	21.2	7.1	3.5	−0.8
5,000–7,500	77,616	9.9	1.8	17.8	−0.2
7,500–10,000	104,890	8.7	0.8	15.4	−0.4
10,000–15,000	167,090	9.1	0.7	6.6	−0.2
15,000–20,000	156,916	13.0	1.2	12.7	−0.5
20,000–25,000	121,529	20.1	0.8	11.1	−0.7
25,000–30,000	92,487	18.2	0.8	17.4	−0.7
30,000–50,000	160,678	20.4	0.7	16.1	−0.3
50,000–100,000	74,601	26.2	0.6	16.8	−0.4
100,000–200,000	19,232	32.4	0.6	19.7	−0.3
200,000–500,000	4,150	38.9	0.6	23.8	−0.4
500,000–1,000,000	432	43.8	0.4	26.1	−0.5
1,000,000 and over	127	49.6	1.1	32.4	−0.1
Total or average	1,149,871	15.4	1.0	13.8	−0.4

Source: Same as table 5.

A final consideration for any analysis focused on stock gains is the degree to which gains or losses on other types of assets might confuse the analysis. Tables 7 and 8 show that 30 percent of all tax returns with gains or losses on corporate stock also have gains or losses on other assets. The degree to which taxpayers use losses on stock, which is a relatively liquid asset, to offset gains on nonstock assets, which may be less liquid, is striking. Nonstock losses are particularly large relative to stock gains in the $1,000,000 and over ordinary-income class, where 59 percent of all returns with net losses on stock have net gains on other assets, and on average there is more than $1 of stock loss for every $2 of nonstock gain. The prevalence of such offsetting gains and losses suggests that the relationship between marginal tax rates and gains on corporate stock cannot be analyzed without regard to other factors.[26]

Two conclusions may be drawn from this analysis. First, estimates of

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[26] For example, an upper income taxpayer with large nonstock gains may show a high first-dollar tax rate on stock gains owing to his normal tax rate and the appli-

Table 8. Relationship of Stock and Nonstock Gains and Losses, Returns with Net Stock Loss, 1973

Adjusted gross income net of capital gains (dollars)	*Number of returns*	*Returns with nonstock net gain*		*Returns with nonstock net loss*	
		Percent of all returns	*Nonstock gain divided by stock loss*	*Percent of all returns*	*Nonstock loss divided by stock loss*
None	12,934	49.3	−4.9	24.1	1.4
0–2,500	59,326	14.3	−7.3	0.9	0.3
2,500–5,000	64,287	17.1	−1.9	2.3	6.8
5,000–7,500	68,609	18.1	−3.0	16.1	2.3
7,500–10,000	65,447	7.7	−2.9	5.8	0.9
10,000–15,000	190,480	16.1	−1.8	7.9	1.7
15,000–20,000	254,904	16.1	−2.6	16.8	0.5
20,000–25,000	196,318	18.9	−2.2	8.5	0.4
25,000–30,000	136,442	26.1	−1.2	10.8	0.2
30,000–50,000	227,225	19.4	−2.0	11.9	1.3
50,000–100,000	102,470	28.6	−2.1	14.2	0.6
100,000–200,000	22,050	38.1	−2.4	13.9	0.6
200,000–500,000	3,858	47.6	−2.9	16.6	1.0
500,000–1,000,000	401	50.6	−4.9	21.9	0.6
1,000,000 and over	148	58.8	−1.9	25.0	0.2
Total or average	1,404,899	19.3	−2.4	11.0	0.7

Source: Same as table 5.

the relationship of tax rates and capital gains realizations must take account of offsetting gain and loss transactions, lest serious errors be made. Second, the timing option often permits tax-free reallocations of investments in corporate stock and other capital assets. For those with holdings large enough to permit diversification, the timing option is particularly significant.

Locking In Caused by Marginal Tax Rates

A final question is the effect of the level of capital gains tax rates on asset holders' decisions to realize. As mentioned earlier, taxes on capital

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cation of the minimum tax and maximum tax offset. If that taxpayer realizes large stock losses to offset those nonstock gains, a regression will show an overlarge negative coefficient on the basis of this nonmarginal strategy. In the opposite case, large nonstock losses (or capital loss carry-overs) may produce a zero tax rate and large positive stock gains in circumstances with little relevance for estimating the elasticity of responses to marginal changes of nonzero tax rates.

gains do make realization and reinvestment less profitable, but because the incentive effects of the tax law are based largely on expectations of the relative future performance of alternative investments, the magnitude of the tax effects in practice is uncertain. Empirical analysis has been limited by a lack of appropriate data, but the 1973 Sales of Capital Assets File permits such analysis.

This analysis is restricted to realizations of gains and losses on corporate stock because stock investments are highly liquid and are typically made for the purpose of capital gain. The analysis here follows the general methodology of Feldstein, Slemrod, and Yitzhaki, but with some refinements.[27]

Even though the capital assets file is by far the richest source of data available on realizations of capital gains, it cannot support analysis that uses a sophisticated structural model of taxpayer behavior.[28] In particular, the lack of information on investors' holdings and purchases of stock, in detail comparable to that on sales, prevents the application of a model based firmly in theory.

Instead, I begin with a reasonable reduced-form model:

> Realized long-term corporate stock gains = *F* (dividends, other income, gains on other assets, carry-over and losses on other assets, itemized deductions, business losses, and the marginal tax rate).

Realization of gains is probably a function of the size of the taxpayer's portfolio. Tax returns provide no direct measure of portfolio size, but the amount of dividends can be used as a proxy indicator.[29] Those with large holdings may be active traders and may realize large fractions of their accrued gains each year. On the other hand, those with small portfolios may realize all their gains in a single sale. Thus the qualitative effect of portfolio size on the amount of gains realized in a given year is uncertain. After finding that the tax rate does not have a statistically significant effect on capital gains realizations for the entire population, Feldstein, Slemrod, and Yitzhaki removed from their sample all cases with dividends of less than $3,000.[30]

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[27] "Effects of Taxation."

[28] The theoretical underpinning of the lock-in effect is the work of Holt and Shelton, "Lock-In Effect," and Sprinkel and West, "Effects of Capital Gains Taxes." The short- and long-run effects of the capital gains tax can be seen from the example presented earlier. An investor paid $500 for stock that has now stabilized in value at $1,000 and that yields 10 percent of current value. With an effective capital gains tax rate of 20 percent, the investor can only be made better off by switching to a stock that yields 11.1 percent or more. If the capital gains tax rate is reduced to 15 percent, stock yielding 10.8 percent or better will increase the investor's income stream. At the time of the tax cut, the investor who held his stock under the higher tax rate would immediately switch if he knew of any alternative asset yielding between 10.8 and 11.1 percent. That is the short-run effect.

In the longer run, a lower capital gains tax rate would reduce the yield differential necessary to induce any investor to switch to an asset of higher yield. If yields fluctuate over time, the lower the capital gains tax rate is, the greater the likelihood in any period that some alternative asset will reach a yield high enough to induce the investor to switch will be. That is the long-run effect.

The theory is complicated in application by investor uncertainty, as well as by the commingling of yield and capital gains objectives.

The equations in this paper likewise show no apparent relationship between tax rates and realizations for the entire population, so tax returns with dividends below $3,000 were removed from the analysis. However, some effort was devoted to finding the degree to which locking in caused by tax rates does appear for various portfolio sizes. Dividends were entered into the equations in a quadratic form to allow for nonlinearities and also as an interaction term with the tax rate.

Income from sources other than stock sales might also influence realization behavior. A small income might induce stock sales to maintain current consumption. A high income would certainly obviate the need for stock sales to maintain consumption, but it might also be associated with financial sophistication and frequent trading. Adjusted gross income net of stock gains is entered into the equations in a quadratic form to allow for nonlinearities. An interaction term with the tax rate is also used. Inclusion of actual stock gains in the income variable would result in multicollinearity with any tax rate on gains. Inclusion of an average amount of stock gains in income would,impart a negative bias to the coefficient (because such a variable would underestimate adjusted gross income for returns with high gains and overestimate income for those with low gains).

In general, older taxpayers would be expected to be more reluctant to realize gains, because appreciation on assets transferred at death would never be subject to income tax. At the same time, older taxpayers, with their reduced labor income, are more likely to need the proceeds of asset sales to maintain accustomed levels of consumption. The incomes of the aged who do not realize gains may be so low that they need not file tax returns, thus making realizations more frequent among the filing population. Further, large stock gains relative to dividends may reflect realizations of capital gains on shares held for long periods of time, which the elderly are most likely to have in their portfolios. Tax returns permit the identification of taxpayers (single or either spouse filing a joint return) over sixty-five years old; a dummy variable is used in the equations to differentiate such returns.

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[29] Feldstein, Slemrod, and Yitzhaki, "Effects of Taxation," p. 781, note that upper income (and thus higher tax rate) shareholders may hold more low-yield growth stocks, citing Marshall E. Blume, Jean Crockett, and Irwin Friend, "Stockownership in the United States: Characteristics and Trends," *Survey of Current Business* (November 1974), p. 18. Such regressions therefore tend to understate the effect of tax rates on realizations.

[30] At the 1973 average dividend payout rate of 3.06 percent (*Economic Report of the President, 1979*, table B-88), this represents a portfolio of almost $100,000. Feldstein, Slemrod, and Yitzhaki, "Effects of Taxation," p. 782, state that tax returns with at least $3,000 of dividends received 79 percent of all dividends reported.

A distinction must be drawn between the effects of temporary and permanent tax rate reduction. A taxpayer might find the capital gains tax rate extraordinarily low in any given year for several reasons. He might choose to borrow heavily in order to invest for gains, and thus have large deductions for investment interest and a taxable income (and thus marginal tax rate) lower than normal. He might choose to make substantial gifts to charity, which are deductible and reduce his taxable income. He may have extraordinary business losses that reduce his gross income below its normal level. Finally, he may have capital losses on assets other than stock (or accumulated loss carry-over) that would offset equal amounts of stock gain.[31] A stockholder with a portfolio of appreciated stock in any of these circumstances might choose to realize some or all of his gains in order to take advantage of his temporarily low marginal tax rate. If tax rates were reduced permanently by law, the same taxpayer might choose to realize those gains in the first year, thus reducing his stock of accrued gains for succeeding years; or he might not react immediately because he could realize those gains in later years at the same tax rates. In any event, the influence of transitory factors must not be confused with the continuous effects of statutory tax rates.

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[31] Alternatively, a taxpayer may realize large capital losses on stock to offset large capital gains on other assets. The IRS Sales of Capital Assets File contains a number of high-income returns with such offsetting gains and losses. Inclusion of these cases in the regression analysis without some control for the offsetting gains and losses overstates the effect of marginal tax rates on realizations. Because those returns show large positive gains before stock losses are considered, their marginal tax rate on gains appears high; the high tax rate is then associated, not with zero gains, but with negative gains, which overstates the absolute value of the negative coefficient. Controlling for the offsetting transactions through an independent variable (as described in the text) has a significant effect on estimated realizations.

To eliminate the transitory effects, several independent variables are added to the regression equations.[32] The sum of capital loss carry-over and gains or losses on assets other than stock (and short-term gains or losses on stock) is included. The value is entered as either a positive or a negative variable, according to its sign, to allow for different taxpayer responses to nonstock gains as opposed to nonstock losses and carry-over. The expected sign is negative, with carry-over and losses on assets other than stock expected to attract offsetting stock gains, and gains on other assets expected to attract stock losses. The amount of business losses is also included, with an expected negative sign. Finally, the amounts of deductions for cash and noncash charitable contributions and interest paid (other than on home mortgages) are included.[33]

The tax rate variable can be defined in several different ways. The effective tax rate on the last dollar of capital gains is the relevant cost for the investor's decision to realize additional gains, though not the cost of realizing the actual gains, and it is strongly collinear with the amount of gains realized. The first-dollar tax rate avoids this multicollinearity, but it is at best not representative of the tax that may be due on a more reasonable amount of gains, and at worst can be very misleading if there are small amounts of carry-over or other losses.[34] Any approximation based on a combination of these two shares their defects. The variable used here is the effective tax rate on a predicted amount of stock gain, which is based on the amounts of dividends and adjusted gross income net of stock gains.[35] This formulation has the virtues of avoiding both the simultaneity of capital gains realizations with the tax rate (because the predicted amount of gain on which the tax rate is calculated is not directly related to the taxpayer's actual gains) and the distortion of the tax rate caused by small amounts of losses or carry-over (because the predicted gain is large enough to swamp typical amounts of losses or carry-over).[36]

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[32] Without these independent variables the equations estimate the short-run effect of the tax on realizations, as described in note 28, above. With the independent variables, the result is closer to the long-run effect.

[33] These deductions represent only 24.9 percent of total itemized deductions for 1973, so there is no danger that the deductions variable will generate an approximate identity between adjusted gross income and taxable income. Internal Revenue Service, *Statistics of Income—1973, Individual Income Tax Returns* (GPO, 1976), pp. 48–49, table 2.2, p. 53, table 2.5, and pp. 56–57, table 2.7.

All of the variables used to control for transitory influences may in some sense be endogenous to the realization decision. For example, while an investor may be encouraged to realize a gain by a large charitable contribution he had made, he might also make such a contribution to reduce the tax on an earlier or subsequent realization. The exact nature of this simultaneous relationship is difficult to model, and because the effect of the independent variables on the estimated elasticities is relatively small, no attempt is made to generalize the model to encompass the simultaneity.

[34] For example, the tax on the first $100 of stock gain for a return with $1,100 of short-term loss carry-over is zero; if the carry-over was only $1,000, however, the gain would be taxed at the ordinary rate, which could be as high as 70 percent. If the typical stock gain for such tax returns was substantially larger than $100, neither of those figures would be indicative of the real tax price of realization.

The equations are estimated with ordinary least squares. All the variables on both sides of the equation are divided by dividends, as a correc-

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[35] The predicted amount of stock gain is the average within fifty-six subpopulations cross-classified by dividends and adjusted gross income.

[36] This approach differs from that of Feldstein, Slemrod, and Yitzhaki, "Effects of Taxation," pp. 780–81. They used an instrumental variable technique predicting the last-dollar tax rate on actual gains, using the last-dollar tax rate on predicted gains and the first-dollar tax rate as instruments. This formulation yields a weighted average of the two tax rates and is unsatisfactory (as was argued above) both because the variable predicted in the first stage is not appropriate for the second-stage equation and because the tax rates used as instruments are subject to distortion from carry-over and losses on other assets. To demonstrate the basic similarity of these two approaches but to isolate the difference, the Feldstein, Slemrod, and Yitzhaki equation was replicated but with the new tax rate formulation. Feldstein, Slemrod, and Yitzhaki report the following result from an unweighted regression (t-statistics are given in parentheses):

$$\begin{aligned} \mathit{GAINS/DIVIDENDS} = 35.0 &+ \underset{(0.50)}{0.18\ \mathit{AGE65}} - \underset{(10.34)}{1.23 \log(\mathit{DIVIDENDS})} \\ &- \underset{(4.31)}{0.50 \log(\mathit{AGI})} - \underset{(13.11)}{0.50\ \mathit{TAX}}, \end{aligned}$$

where *GAINS* is long-term gains on stock, *AGE65* is a dummy variable taking the value 1 if a personal exemption for sixty-five or over is claimed, *AGI* is adjusted gross income net of stock gains plus predicted stock gains in *AGI* (based on net *AGI* and dividends), and *TAX* is the instrumental variable (no first-stage equation is reported). When the tax rate is changed to the formulation to be used in this paper, the result is:

$$\begin{aligned} \mathit{GAINS/DIVIDENDS} = 30.17 &+ \underset{(1.07)}{0.36\ \mathit{AGE65}} - \underset{(10.85)}{1.22 \log(\mathit{DIVIDENDS})} \\ &- \underset{(10.74)}{0.80 \log(\mathit{AGI})} - \underset{(17.02)}{0.25\ \mathit{TAX}}. \end{aligned}$$

The Feldstein, Slemrod, and Yitzhaki result implies an elasticity of realizations with respect to the tax rate of −23.8; the result with the new tax rate is −11.8. Though numerically different, both estimated elasticities might fairly be described as astronomical. These results are presented only to compare the Feldstein, Slemrod, and Yitzhaki and the new tax rate formulations; it will be shown below that all the coefficients in both these equations are greatly biased.

tion for heteroscedasticity.[37] The results of the equation are shown in table 9. Equation 1, for returns with dividends of at least $3,000 and omitting the independent variables for the transitory effects, shows that long-term stock gains over the relevant range is a decreasing function of income from sources other than stock and an increasing function of dividends, all else being equal.[38] The dummy variable for elderly taxpayers shows a negative and statistically significant coefficient, indicating that the inhibiting effect of potential tax avoidance through step-up of basis overrides the greater financial need of some of the elderly and leads to lower stock sales in that group.

The tax rate and interaction coefficients in equation 1 yield an elasticity estimate of −0.44 at the means of all the variables, indicating that a capital gains tax rate reduction would result in a loss of tax revenue. However, such an inference must be considered tentative in light of the a priori arguments expressed earlier for either a rising or a falling elasticity with respect to portfolio size. Equation 1 allows an examination of this question because its interaction terms generalize the relationship between the elasticity and portfolio size. The next to last line in table 9 shows that the estimated elasticities are −0.21 in the $3,000–$10,000 dividend class, −0.31 in the $10,000–$20,000 class, −0.42 in the $20,000–$50,000 class, and −1.49 for recipients of dividends of $50,000 and over. Thus only for portfolios of over approximately $1,500,000 of corporate stock

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[37] The same equation without the normalization of all variables by dividends (for returns with at least $3,000 of dividends) provides approximately the same elasticity estimate at the mean dividend, income, and tax rate values as the normalized equation, but elasticity estimates at typical variable values for portfolio sizes larger than average rise until, for returns with more than $50,000 in dividends, they are counterintuitively positive.

[38] Feldstein, Slemrod, and Yitzhaki ("Effects of Taxation") found a strongly significant negative relationship to dividends. The differences between their findings and mine apparently result because they used an unweighted regression and I computed with the sample weights. Weighting of the regressions is required because the sample is selected according to stratified sampling rates based on adjusted gross income, which includes all of short-term and one-half of long-term capital gains. Therefore, all else being equal, returns with larger capital gains are more likely to be in the sample than returns with smaller gains. Under these circumstances coefficients derived through ordinary least squares will be biased. Weighted least squares produces consistent estimates, though the accuracy of the estimates of the standard errors depends on the sample size, which in this case is extremely large. See Jerry A. Hausman and David A. Wise, "Stratification on Endogenous Variables and Estimation: The Gary Income Maintenance Experiment," in Charles Manski and Daniel McFadden, eds., *Econometric Analysis of Discrete Data* (MIT Press, forthcoming).

Table 9. Regression Results on Realizations of Long-Term Stock Gains, 1973

Independent variable[a] *or summary statistic*	*Dividend class and equation number*					
	$3,000 and over (*1*)	*$3,000 and over* (*2*)	*$3,000–$10,000* (*3*)	*$10,000–$20,000* (*4*)	*$20,000–$50,000* (*5*)	*$50,000 and over* (*6*)
Constant	2,925	1,946	3,565	−27,390	−50,460	40,900
	(4.259)	(2.876)	(1.219)	(1.420)	(3.435)	(3.965)
Age dummy	−1,231	−731.6	−649.4	−1,216	−4,357	−4,180
	(3.686)	(2.217)	(1.138)	(0.937)	(2.914)	(1.280)
Dividends	0.5121	0.3807	−0.08057	4.276	3.405	0.2652
	(4.157)	(3.123)	(0.072)	(1.495)	(3.571)	(1.941)
Dividends^2	0.3865 (10^{-6})	−0.4311 (10^{-7})	0.2733 (10^{-4})	−0.1213 (10^{-3})	−0.2955 (10^{-4})	−0.1348 (10^{-6})
	(0.550)	(0.063)	(0.272)	(1.199)	(1.968)	(1.253)
Adjusted gross income	0.008712	0.002423	0.007469	−0.1208	−0.1355	−0.2439
	(1.184)	(0.306)	(0.535)	(5.402)	(6.325)	(9.884)
Adjusted gross income^2	0.8561 (10^{-9})	−0.3746 (10^{-8})	−0.5716 (10^{-8})	0.1794 (10^{-9})	−0.2385 (10^{-8})	0.5046 (10^{-8})
	(1.470)	(4.959)	(4.057)	(0.057)	(0.351)	(7.153)
Gains on other assets	...	−0.1093	−0.1260	−0.05393	−0.05382	−0.07818
	...	(15.650)	(9.879)	(3.146)	(3.876)	(5.456)
Carry-over plus losses on other assets	...	−0.001871	0.03498	−0.1700	−0.3598	−0.0369
		(0.105)	(1.076)	(4.138)	(12.356)	(2.183)
Interest deductions	...	0.2473	0.2224	0.4987	0.0986	0.2227
		(5.750)	(2.861)	(4.703)	(1.196)	(3.201)
Cash charitable contributions deductions	...	1.010	0.9633	1.170	0.9415	0.9552
		(12.940)	(6.658)	(7.497)	(6.941)	(7.926)

Noncash charitable contributions deductions	. . .	1.939	1.859	2.363	2.351	2.808
		(21.698)	(11.106)	(12.970)	(15.394)	(31.472)
Business losses	. . .	−0.1257	−0.1526	−0.009194	−0.1936	−0.2222
		(11.371)	(7.497)	(0.346)	(7.982)	(9.099)
Marginal tax rate	−524.8	−334.4	−445.4	. . .[b]	1,119	−1,109
	(8.284)	(5.281)	(4.380)		(3.312)	(2.693)
Marginal tax rate^2	28.63	13.20	16.15	. . .[b]	. . .[b]	. . .[b]
	(12.664)	(5.521)	(3.757)			
Marginal tax rate times dividends	−0.01569	−0.01321	. . .[b]	−0.02378	−0.06334	−0.01187
	(2.352)	(2.007)		(3.196)	(5.051)	(2.267)
Marginal tax rate times AGI	−0.004812	−0.001658	−0.002059	0.004174	0.003683	0.00492
	(14.452)	(3.943)	(2.729)	(4.021)	(4.013)	(5.793)
Corrected $\bar{R}^2$	0.0170	0.0560	0.0586	0.0758	0.1313	0.1453
F	58.47	119.29	42.54	30.98	62.66	123.39
(Degrees of freedom)	(9; 29,879)	(15; 29,873)	(14; 9,323)	(13; 4,741)	(14; 5,698)	(14; 10,068)
Corrected standard error of estimate	5.065	4.963	5.624	3.384	2.040	2.109
Elasticity from own equation	−0.44	−0.79	−0.76	−0.79	−1.08	−1.27
Elasticity from equation 1	−0.44	−0.44	−0.21	−0.31	−0.42	−1.49
Elasticity from equation 2	−0.79	−0.79	−0.65	−0.86	−0.70	−1.22

Source: Internal Revenue Service Sales of Capital Assets File. Standard errors of the variables are in parentheses.

a. The dependent variable is long-term stock gains. All variables are divided by dividends.

b. Coefficient failed test of statistical significance; variable was therefore omitted from equation for computation of elasticity.

would capital gains tax cuts generate sufficient additional realizations to result in an increase in revenue.

Equation 2 uses the same general specification on the same population but adds the variables used to control for fluctuations in tax rates. The relationship of gains to adjusted gross income becomes significant and negative rather than insignificant and positive. The variable for gains on other assets shows a large and significant negative coefficient, as expected. This coefficient is consistent with the data in tables 7 and 8, which demonstrated that many taxpayers seek to match their realized gains on other assets with stock losses to minimize their tax liabilities. The variable for nonstock losses (including carry-over) has a smaller coefficient and is statistically insignificant. The business loss variable is also significant with the expected sign. The variables for itemized deduction items all show the expected sign and statistical significance. The elasticity estimate for the entire population is −0.79, which is higher than that for the equation without the additional independent variables. The puzzle of this discrepancy is somewhat reduced when the elasticities for various portfolio sizes are computed. As shown in the bottom line of table 9, equation 2 yields elasticities of −0.65, −0.86, −0.70, and −1.22 for the dividend classes in ascending order. It is reasonable that the independent variables for transitory influences reduce the measured tax effect most for taxpayers with large portfolios, who would tend to be more diversified and thus to have some shares that could profitably be switched with a temporary reduction in their effective tax rates. Taxpayers with smaller portfolios would be less likely to respond to fluctuations in tax rates because their portfolios would probably be less diversified, and measurement of the incremental effect of the fluctuations might therefore be more tentative.

To confirm the elasticities estimated from equation 2, the same equation was run on subsamples corresponding to the dividend classes specified above. The elasticity estimates were quite similar at −0.76, −0.79, −1.08, and −1.27. These results suggest again that taxpayers with stock portfolios larger than $1,500,000 would increase their realizations of gains by a greater percentage than a cut in the capital gains tax, and further indicate that those in the $600,000–$1,500,000 range would increase realizations very slightly more than tax rates were reduced. The range of elasticities for the regressions on the subsamples is thus slightly higher than would be expected from the overall elasticity estimated in equation 1.

Apart from the elasticity estimates, the subsamples confirm the expected signs on the control variables for deductions and gains and losses on other assets. The only unexpected sign arises in the smallest portfolio class for the coefficient on carry-over and losses on other assets, but that coefficient is not statistically significant.

Why does the top end of the wealth distribution respond so much more strongly to variations in tax rates? Two possibilities come to mind. First, the potential absolute variation in tax rates is much greater for those who are wealthiest. This is simply because their highest potential tax rate is much larger than the highest potential rate for those with smaller property incomes (while the lowest possible rate is zero for both groups). This larger range of tax rates suggests that tax minimization is more profitable for wealthier taxpayers because the same change in tax rates means more to the recipient of a larger amount of gains.

Second, it is entirely possible that the incomes and deductions of the well-to-do fluctuate more than those of the less well-off. The equations identify likely causes of lower than average taxable income, and the relevant variables generally have large coefficients of the expected sign. However, it is much more difficult to identify *above* average taxable income when items from all sources are extremely large. Thus taxpayers who have small realizations and high tax rates may be responding to upward fluctuations of income and would time their realizations in the same fashion even if statutory tax rates were lower.

It is possible, with the results of equations 3 through 6 in table 9, to estimate the revenue effect of the capital gains tax provisions of the Revenue Act of 1978 at 1973 income and capital gains levels.[39] Realized stock gains increase by 5.3 percent, with most of that growth at income levels in excess of $50,000. Table 10 shows the resulting change in tax liabilities. Tax revenues are reduced by $692 million, or 5.8 percent, and 65 percent of the tax reduction is received by taxpayers with incomes over $100,000.[40]

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[39] The features included are the reduction of the portion of long-term gains included in adjusted gross income from 50 to 40 percent, and the removal of the excluded portion of long-term gains from tax preferences in the minimum tax and the maximum tax. The change in the law is assumed to have no effect on taxpapers with less than $3,000 of dividends.

[40] Use of the coefficients from either equation 1 or equation 2 would result in a greater revenue loss than that presented in table 10. This revenue loss estimate includes transactions in corporate stock only. It is highly likely that sales of other assets are far less tax sensitive, because stock is the most liquid asset generally purchased to achieve capital gains. For this reason, the actual revenue loss for transactions in all assets is probably significantly greater than the estimate for only corporate stock.

Table 10. Changes in Tax Liability Resulting from the Capital Gains Tax Reductions of the Revenue Act of 1978, 1973 Income Levels

Adjusted gross income (dollars)	*Number of returns[a] (thousands)*	*1973 tax liability (millions of dollars)*	*Tax liability under 1978 act (millions of dollars)*	*Change in tax liability (millions of dollars)*	*Change in tax liability (percent)*	*Change in tax liability (dollars per return)*
Less than 0	15.1	11.6	1.9	−9.7	−83.9	−645.4
0–2,500	83.3	0.3	0.0	−0.3	−98.0	−3.6
2,500–5,000	98.8	9.5	8.6	−0.9	−9.1	−8.8
5,000–7,500	106.3	33.6	30.8	−2.8	−8.4	−26.5
7,500–10,000	119.8	85.1	83.7	−1.4	−1.7	−12.0
10,000–15,000	244.7	324.0	317.4	−6.6	−2.0	−27.1
15,000–20,000	310.6	666.6	652.4	−14.3	−2.1	−46.0
20,000–25,000	245.0	726.4	708.2	−18.1	−2.5	−74.0
25,000–30,000	171.4	666.6	657.6	−9.0	−1.4	−52.6
30,000–50,000	329.3	2,316.9	2,241.8	−75.2	−3.2	−228.2
50,000–100,000	171.6	2,748.6	2,647.2	−101.5	−3.7	−591.5
100,000–200,000	48.0	1,964.6	1,843.8	−120.8	−6.1	−2,516.8
200,000–500,000	11.6	1,239.7	1,101.5	−138.2	−11.1	−11,880.3
500,000–1,000,000	1.7	495.1	413.6	−81.5	−16.5	−48,030.0
1,000,000 and over	0.6	546.2	434.6	−111.6	−20.4	−181,501.1
Total or average	1,957.6	11,834.9	11,143.0	−691.9	−5.8	−353.4

Sources: Internal Revenue Service 1973 Sales of Capital Assets File and Individual Tax Model File.

a. With dividends of at least $3,000.

Summary and Conclusions

This paper has presented research in two areas that have been largely unexplored in the past owing to a lack of appropriate data. The bunching of capital gains was found to increase tax liabilities for about 88 percent of those who realized gains. However, this leaves 12 percent who time their realizations of capital gains in years when they are subject to low tax rates because their incomes are lower or their deductions higher than usual. This smaller group disproportionately includes those with large capital gains. The five-year averaging provision in the law already provides some relief for those whose gains are taxed at higher than average rates because of bunching. The other side of the coin—the self-averaging permitted taxpayers through the timing of realizations—is a benefit of the current tax system that is often ignored.

The second new feature of this analysis is the identification of the use of realizations of offsetting capital gains and losses in a single year as a tax-minimization device. The data indicate that higher income taxpayers are likely to realize offsetting gains and losses; such taxpayers have diversified portfolios and may thus realize accrued gains without incurring any tax liability. This tendency is not restricted to relatively liquid assets like stock; rather, other assets were traded in offsetting transactions, and there was a striking tendency for stock losses to be used to offset nonstock gains. These results suggest that taxpayers with small net gains or losses may in many cases have reallocated substantial shares of their portfolios in offsetting transactions, sometimes among several types of assets.

Additional evidence regarding the lock-in effect of the capital gains tax has also been presented. Available estimates of the lock-in effect have been quite imprecise. The most recent estimate indicated an extremely large, continuing lock-in effect. Much of this large measured effect was caused by an incorrect statistical procedure; much of the remainder was the response of taxpayers to fluctuations in their own effective tax rates, as opposed to the level of statutory capital gains rates. This same timing of gains in low tax rate years (and losses in high tax rate years) can be expected whatever the statutory capital gains rates. Once this timing response was removed, the continuing additional realizations to be expected from reductions in capital gains tax rates was found to be much smaller than previous estimates. Further, taxpayers who responded sufficiently to capital gains tax cuts to produce increased federal tax revenue were shown to be a small segment of the population (those with stock portfolios larger than $600,000). As a result, the capital gains tax reduction in 1978 reduced tax revenues on balance.

Appendix A: History of the Capital Gains Tax Provisions

This appendix provides a brief history of the treatment of capital gains under the federal individual income tax. The discussion is limited to the required holding period for preferential treatment; the fraction of capital gains included in adjusted gross income; alternative or additional taxes on gains; the treatment of capital losses; the definition of assets eligible for capital gains treatment; and the deferral of tax on realized gains.[41]

A summary of the holding period, inclusion, alternative tax, and loss-offset provisions is presented in table 11. The capital gains preference has taken the form of an exclusion of part of the gain from adjusted gross income and a limited maximum rate of tax on the gain, provided the gain has been held for some minimum length of time. As is evident from the table, both the minimum holding period required to qualify for the exclusion and the rate of the exclusion itself have changed considerably over the history of the individual income tax. From the introduction of the income tax in 1913 until 1921 there was no preference. In 1922, a 12½ percent alternative tax rate for gains on assets held at least two years was introduced. From 1934 through 1937 long-term gains fell into four categories according to the length of holding period; the longer an asset was held, the smaller the portion of the gain included in taxable income. From 1938 through 1941 there were two categories of long-term gains, with the inclusion rate again lower for assets held longer. The simple long-term–short-term dichotomy was reinstated in 1942 and has endured. In addition to the exclusion, a maximum tax rate on gains was in effect from 1938 until 1968, varying from 15 to 26 percent. Under the 1969 act the maximum rate of 25 percent was restricted to the first $50,000 of long-term gain; it was repealed entirely for tax years beginning in 1979.

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[41] More complete, though dated, treatments of these questions are available in David, *Alternative Approaches to Capital Gains Taxation;* and *The Federal Tax System: Facts and Problems*, Committee Print, Joint Economic Committee, 88 Cong. 2 sess. (GPO, 1964).

Since 1969 there have been, under certain circumstances, additional taxes on capital gains. The first of these, the so-called minimum tax, was designed to increase the tax on large long-term capital gains. The excess of the excluded portion of long-term gains (plus certain other preferences) over certain exemptions and deductions was taxed at a flat rate (10 percent through 1975 and 15 percent thereafter).[42] Beginning in 1979 the excluded portion of capital gains was removed from the minimum tax base and added to the the base of a new alternative minimum tax, which also included all of adjusted gross income less personal exemptions and itemized deductions claimed for medical expenses and casualty losses. The alternative minimum tax base was subjected to a progressive tax rate schedule that ranged from 10 to 25 percent. The final tax liability is the ordinary tax or the alternative minimum tax, whichever is greater.[43] The premise of the alternative minimum tax is thus that the tax liability should not be less than some fraction of gross income, unless extraordinary medical expenses or casualty losses significantly reduce the ability to pay.

Because capital gains receive preferential treatment, some taxpayers expend considerable legal effort to convert ordinary income into capital gains. The Internal Revenue Service and the Congress have retaliated with legislation and regulations. The result is a legal battleground that encompasses over half of the internal revenue code and a large fraction of the workload of tax administrators.

Capital gains were first defined in the law in 1922, when the preferential treatment of long-term gains began. The principles behind the definition have remained the same ever since. The law first defines capital assets as property, and then excludes certain types of property from that definition. The two most important exclusions are the incomes received in the ordinary course of business (such as the sale of a manufacturer's product)

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[42] As of 1979, only tax preference items in excess of one-half of ordinary tax liability or $10,000, whichever was larger, were subject to the minimum tax. Tax preference items other than the excluded half of long-term capital gains included excess itemized deductions, accelerated depreciation on low-income rental housing or other real property, accelerated depreciation on personal property, amortization of pollution control or child care facilities, stock options, bad debt reserves of financial institutions, depletion, and intangible drilling costs.

[43] Technically, the alternative minimum tax is equal to the excess of that tax, computed on the alternative minimum tax base and the 10–25 percent rate schedule, over the ordinary tax, computed in the usual way; the taxpayer then pays the ordinary tax plus the alternative minimum tax, if any.

Table 11. History of the Capital Gains Provisions under the Federal Individual Income Tax

Tax year or period	*Holding period*	*Percent of gain taxed as ordinary income*	*Alternative tax (highest rate on long-term gains)*	*Treatment of losses*
1913–15	All	100	None (highest rate: 7 percent)	Not deductible
1916–17	All	100	None (highest rate: 15 percent in 1916, 65 percent in 1917)	Deductible only from capital gains
1918–21	All	100	None (highest rate: 77 percent in 1918, 73 percent in 1919–21)	Deductible in full from income of any kind
1922–23	2 years or less	100	None	Deductible in full from ordinary income, but not from capital gains
	Over 2 years	100	12½ percent; but total income tax must be no less than 12½ percent of total net income	Deductible in full from income of any kind
1924–31	2 years or less	100	None	Deductible in full from income of any kind
	Over 2 years	100	12½ percent	Creditable at 12½ percent, provided total income tax is no less than if losses were deducted in full from ordinary income
1932–33	2 years or less	100	None	Losses from stocks and bonds deductible only from gains on stocks and bonds. Other losses deductible in full from income of any kind
	Over 2 years	100	12½ percent	Creditable at 12½ percent, provided total income tax is no less than if losses were deducted in full from ordinary income
1934–37	1 year or less	100	None	Net losses, reduced by the appropriate inclusion rate based on the holding period, deductible to the extent of included capital gains plus $2,000
	Over 1 year to 2 years	80	None (highest rate: 50.4 in 1934–35, 63.2 in 1936–37)	

	Over 2 years to 5 years	60	None (highest rate: 37.8 in 1934–35, 47.4 in 1936–37)	
	Over 5 years to 10 years	40	None (highest rate: 25.2 in 1934–35, 31.6 in 1936–37)	
	Over 10 years	30	None (highest rate: 18.9 in 1934–35, 23.7 in 1936–37)	
1938–41	18 months or less	100	None	Deductible only from gains on assets held 18 months or less; excess losses to the extent of net income may be carried forward to the next tax year
	Over 18 months to 2 years	66⅔	30 percent of included gain (highest rate: 20 percent in 1938–39 and 1941, 22 percent in 1940)	Net loss reduced by the appropriate inclusion rate deductible from other income or creditable at 30 percent, whichever gives the greater tax
	Over 2 years	50	30 percent of included gain (highest rate: 15 percent in 1938–39 and 1941, 16.5 percent in 1940)	
1942–51	6 months or less	100 (of excess over 50 percent of long-term loss, if any)	None	Net loss (short-term loss plus 50 percent of long-term loss, or excess of short-term loss over 50 percent of long-term gain, or excess of 50 percent of long-term loss over short-term gain) deductible from included gain plus $1,000 of ordinary income; excess carried forward for 5 years as short term loss
	Over 6 months	50 (less short-term loss, if any)	25 percent (26 percent effective September 1, 1951)	
1952–63	6 months or less	100 (of excess over long-term loss, if any)	None	Net loss (sum of long- and short-term loss, or excess of short-term loss over long-term gain, or excess of long-term loss over short-term gain) deductible from other income up to $1,000; excess carried forward for 5 years as a short-term loss
	Over 6 months	50 (of excess over short-term loss, if any)	26 percent (1952–53) 25 percent (1954–63)	

Table 11 (*continued*)

Tax year or period	*Holding period*	*Percent of gain taxed as ordinary income*	*Alternative tax (highest rate on long-term gains)*	*Treatment of losses*
1964–69	6 months or less	100 (of excess over long-term loss, if any)	None	Net loss (sum of long- and short-term loss, or excess of short-term loss over long-term gain, or excess of long-term loss over short-term gain) deductible from other income up to $1,000; excess short-term losses carried forward indefinitely as short-term loss, excess long-term losses carried forward indefinitely as long-term loss; short-term loss carry-overs used first
	Over 6 months	50 (of excess over short-term loss, if any)	25 percent	
1970–76	6 months or less	100 (of excess over long-term loss, if any)	None	Net loss (sum of short-term loss and 50 percent of long-term loss, or excess of short-term loss over long-term gain, or 50 percent of excess of long-term loss over short-term gain) deductible from other income up to $1,000; excess short-term losses carried forward indefinitely as short-term loss; excess long-term losses carried forward indefinitely as long-term loss; short-term loss carry-overs used first
	Over 6 months	50 (of excess over short-term loss, if any)	25 percent on first $50,000 of gain only. Additional tax of 10 percent (15 percent in 1976) on excluded half of gain under certain circumstances (highest rate: 0.3221375 in 1970; 0.3875 in 1971; 0.455 in 1972–75; 0.49125 in 1976)	
1977	9 months or less	100 (of excess over long-term loss, if any)	None	Net loss (sum of short-term loss and 50 percent of long-term loss, or excess of short-term loss over long-term gain, or 50 percent of excess of long-term loss over short-term gain) deductible from
	Over 9 months	50 (of excess over short-term loss, if any)	25 percent on first $50,000 of gain only. Additional tax of 15 percent	

			on excluded half of gain under certain circumstances (highest rate: 0.49125)	other income up to $2,000; excess short-term losses carried forward indefinitely as short-term loss; excess long-term losses carried forward indefinitely as long-term loss; short-term loss carry-overs used first
1978	1 year or less	100 (of excess over long-term loss, if any)	None	Net loss (sum of short-term loss and 50 percent of long-term loss, or excess of short-term loss over long-term gain, or 50 percent of excess of long-term loss over short-term gain) deductible from other income up to $3,000; excess short-term losses carried forward indefinitely as short-term loss; excess long-term losses carried forward indefinitely as long-term loss; short-term carry-overs used first
	Over 1 year	50 (40 after October 31 only) (of excess over short-term loss, if any)	25 percent on first $50,000 of gain only. Additional tax of 15 percent on excluded half of gain under certain circumstances (highest rate: 0.49125 January 1–October 31; 0.349 November 1–December 31)	
1979	1 year or less	100 (of excess over long-term loss, if any)	None	Net loss (sum of short-term loss and 50 percent of long-term loss, or excess of short-term loss over long-term gain, or 50 percent of excess of long-term loss over short-term gain) deductible from other income up to $3,000; excess short-term losses carried forward indefinitely as short-term loss; excess long-term losses carried forward indefinitely as long-term loss; short-term loss carry-overs used first
	Over 1 year	40 (of excess over short-term loss, if any)	Graduated additional tax on full amount of gains under certain circumstances (highest rate: 28 percent)	

Sources: U.S. Department of the Treasury, *Federal Tax Rates, 1913 to 1940* (Government Printing Office, 1941), pp. 530–32, and *Federal Tax Rates, 1940 through 1950* (GPO, 1951), pp. 277–78; *Revenue Act of 1951*, H. Rept. 586, 82 Cong. 1 sess. (GPO, 1951); *Brief Summary of the Provisions of H.R. 8363, "The Revenue Act of 1964,"* Committee Print, Senate Committee on Finance, 88 Cong. 2 sess. (GPO, 1964); *Tax Reform Act of 1969*, H. Rept. 91-782, 91 Cong. 1 sess. (GPO, 1976), pp. 162–69; *Tax Reform Act of 1976*, H. Rept. 94-1515, 94 Cong. 2 sess. (GPO, 1976), pp. 232–35; and *General Explanation of the Revenue Act of 1978*, Committee Print, Joint Committee on Taxation, 96 Cong. 1 sess. (GPO, 1979), pp. 251–60.

and gains on property used in a trade or business. In both of these general categories, however, numerous exceptions have been made. For example, in 1943 gains from sales of timber were defined as capital gains even though the timber might be sold routinely in the ordinary course of business. Gains from sales of coal (1951) and iron ore (1964) royalty rights were defined as capital gains, even though the royalties themselves would have been taxed to the original owner as ordinary income.[44] Likewise, certain business assets can be sold for capital gains so long as recovery of depreciation already taken against ordinary income is taxed in full. Taxpayers continue to test the capital gains definition with their particular circumstances, and the resolution of each case adds to the already large body of legislation, regulations, rulings, and case law.

Just as capital gains are not added in full to taxable income, so capital losses are not subtracted in full. From 1913 through 1916 capital losses could not be offset against capital gains at all. Since that time, the law has been more generous—allowing losses to be offset against gains, allowing net losses to be carried forward to later tax years, or allowing the offset of some (in certain years, all) of capital losses against ordinary income.[45] Treatment of losses is an important economic issue because risk-taking is affected by the treatment of both successful and unsuccessful risks.

The tax law has always recognized capital gains when they are realized rather than as they accrue. This presents an important opportunity for tax reduction by holding rather than selling appreciating assets. By postponing sale, the owner of appreciating property implicitly allows all of his investment to earn its current market return instead of selling the asset and reinvesting only the after-tax proceeds at the market rate. Certain provisions of the tax code extend the opportunity of deferral to involuntary conversions, exchanges of property of like kind, certain exchanges of insurance policies, and certain exchanges of securities in corporate organizations, reorganizations, and mergers. Still another opportunity is probably the most common: the deferral of recognition of the fully reinvested gain on owner-occupied homes.

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[44] *Revenue Act of 1951*, H. Rept. 586, 82 Cong. 1 sess. (GPO, 1951); and *Brief Summary of the Provisions of H.R. 8363, "The Revenue Act of 1964,"* Committee Print, Senate Committee on Finance, 88 Cong. 2 sess. (GPO, 1964), p. 6.

[45] The offsetting of short-term losses against long-term gains is itself an issue, since all of short-term but only part of long-term gains are included in adjusted gross income. From 1942 through 1951 short-term losses were deducted from *the portion of long-term gains that was included* in adjusted gross income. This allowed taxpayers to realize long-term gains and half as much in short-term losses and pay no tax; it also meant that taxpayers realizing equal amounts of short-term gains and long-term losses were taxed on half their gains at ordinary rates. Since that time, short-term losses have been deducted from *total* long-term gains before the included portion is computed.

One of the most significant deferral opportunities is available through the transfer of assets either by gift or at death. Property transferred by gift is subject to federal gift taxation, but no income tax is assessed on the accrued gain. The donee receives the property subject to the donor's basis with an adjustment for gift taxes paid, and if the donee chooses to sell the property, capital gains taxes are collected on the entire appreciation from the date the donor acquired it. Property transferred by bequest is subject to the federal estate tax, but again the appreciation goes untaxed under the income tax. Further, the donee accepts as the basis the value of the property as of the time of bequest, meaning that any appreciation accrued during the donor's lifetime is never subject to capital gains tax. The deferral of taxation through gift or bequest is considered a major problem by some tax experts, because appreciating property can change hands between generations without capital gains tax, thus increasing the concentration of wealth. Further, property owners may keep assets that are economically inferior to available alternatives because the present value of the tax savings at death will exceed the yield differential between the assets, capitalized and discounted over the owner's expected lifetime.

Appendix B: Historical Data on Capital Gains

Realizations of capital gains are extremely volatile over time, as is shown in table 12. Several offsetting factors are at work. When assets appreciate and gains accrue more rapidly, some taxpayers choose to realize those gains rather than leave them at risk. Taxpayers with accrued losses have incentives to realize them in order to offset gains, and to move them into apparently more profitable assets. When asset prices are stable or falling, there is less appreciation to realize, but stagnant and falling incomes with no gains encourage realizations to maintain consumption levels. Losses are also likely to be realized to maintain consumption, but published statistics generally do not reveal the true extent of loss realizations because of the limitation on loss offsets against ordinary income.

Table 12 indicates that realizations are significantly correlated with the state of the economy and of the stock market. Net gains are significantly positively correlated with both the level of corporate profits and stock

Table 12. Realized Net Capital Gains and Net Capital Losses on Individual Income Tax Returns and Selected Economic Indicators, 1954–77

Year	*Net gains (thousands of dollars)*	*Net losses (thousands of dollars)*	*Corporate profits (billions of dollars)*	*Standard and Poor's index*	*Percent change, gross domestic product deflator*	*Real rate of growth of GNP (percent)*	*Baa corporate bond rate (percent)*
1954	3,731,862	379,446	37.8	29.69	1.4	−1.3	3.51
1955	5,126,350	375,213	46.7	40.49	2.2	6.7	3.53
1956	4,991,131	438,465	45.9	46.62	3.2	2.1	3.88
1957	4,128,228	642,695	45.4	44.38	3.4	1.8	4.71
1958	4,879,114	549,110	40.8	46.24	1.6	−0.2	4.73
1959	6,796,602	522,115	51.2	57.38	2.2	6.0	5.05
1960	6,003,859	704,284	48.9	55.85	1.7	2.3	5.19
1961	8,290,879	670,085	48.7	66.27	0.9	2.5	5.08
1962	6,821,421	1,050,393	53.7	62.38	1.8	5.8	5.02
1963	7,468,326	1,019,344	57.6	69.87	1.5	4.0	4.86
1964	8,909,143	969,991	64.2	81.37	1.6	5.3	4.83
1965	11,069,464	888,606	73.3	88.17	2.2	5.9	4.87
1966	10,960,261	1,018,979	78.6	85.26	3.3	5.9	5.67
1967	14,593,683	911,798	75.6	91.93	2.9	2.7	6.23
1968	18,853,870	864,221	82.1	98.70	4.5	4.4	6.94
1969	16,078,215	1,494,887	77.9	97.84	5.0	2.6	7.81
1970	10,655,553	1,648,870	66.4	83.22	5.4	−0.3	9.11
1971	14,558,580	1,403,581	76.9	98.29	5.1	3.0	8.56
1972	18,396,678	1,321,387	89.6	109.20	4.1	5.7	8.16
1973	18,200,682	1,529,396	97.2	107.43	5.8	5.5	8.24
1974	15,377,899	1,907,774	86.5	82.85	9.7	−1.4	9.50
1975	15,799,165	1,727,272	107.9	86.16	9.6	−1.3	10.61
1976	20,207,101	1,645,248	141.4	102.01	5.2	5.7	9.75
1977	23,363,333	2,586,729	159.1	98.20	5.9	4.9	8.97

Sources: Internal Revenue Service, *Statistics of Income: Individual Tax Returns*, various years; *Economic Report of the President, 1979*, tables B-2, B-3, B-19, B-65, and B-88.

market indexes, as are changes in net gains.[46] Profits and stock market indexes are also positively correlated with the absolute value of net losses, indicating that asset holders respond to rising prices by cashing in their losses for more profitable reinvestment or by offsetting their gains with losses. Upward movements in profits and the stock market are correlated with smaller loss realizations, however, because rising markets wipe out some accrued losses. Faster growth and acceleration of growth of the gross national product are associated with increased realization of net gains. High interest rates are associated with greater net gains and net losses; rising interest rates are associated with decreases in realizations of net gains and increases in realizations of net losses. Net gains and net losses tend to be larger when the inflation rate is higher; an acceleration of inflation is associated with an increase in net losses.

Comments by James W. Wetzler

Whenever it cuts the capital gains tax rate, Congress claims that the additional transactions induced by the tax cut will prevent any decline in revenues, and whenever it raises the tax rate, Congress claims credit for the assumed revenue gain with little reference to possible lock-in effects. The most recent cycle in congressional attitudes on lock-in lasted only two years. Clearly, empirical research to narrow the range of disagreement on this issue is a high priority, and both Joseph Minarik and Martin Feldstein, Joel Slemrod, and Shlomo Yitzhaki, on whose work Minarik builds, should be commended for undertaking the assignment.[47]

How much do economists really know about the extent to which changes in tax rates on capital gains affect investors' decisions to sell assets? I am afraid that, despite the best efforts of Minarik and Feldstein-Slemrod-Yitzhaki, the answer is, relatively little.

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[46] This reflects the important role of gains on corporate stock in total gains. In 1962 stock transactions accounted for $7.1 billion of $17.3 billion total gross gains and $4.1 billion of $6.3 billion total gross losses. Internal Revenue Service, *Statistics of Income—1962, Supplemental Report: Sales of Capital Assets Reported on Individual Income Tax Returns*, table 1, p. 21. The inferences discussed here are based on correlation coefficients rather than a general regression model because the various measures of economic conditions are highly collinear among themselves. Without a richer body of time series data, these results should be taken as tentative.

[47] Feldstein, Slemrod, and Yitzhaki, "Effects of Taxation."

Let me start with the relevant theory, which logically should precede any empirical work but which is omitted by both Minarik and Feldstein-Slemrod-Yitzhaki. It is easy to show that a wealth-maximizing investor who owns an asset that has appreciated in value will not sell that asset and switch to an alternative asset unless the expected rate of return on the alternative investment is enough higher than that on the original asset to justify the capital gains tax on the appreciation and other costs of making the transaction. The extra rate of return on the alternative asset needed to induce the switch is proportional to the capital gains tax rate and to the ratio of the appreciation on the asset to its value. If there is a step-up in basis at death, the needed excess return also varies inversely with life expectancy.[48]

Investors' expectations about rates of return on different assets are unobservable, of course. Therefore, to derive any testable hypotheses, some assumptions must be made about how these expectations are formed and how they change over time. For example, it might be assumed that, having just bought an asset, an investor expects it to have a higher rate of return than any alternative assets but that, as time passes, his expectations about the rate of return on his own asset and on alternative assets follow random walks. Eventually, these fluctuations in expectations will cause some alternative asset to improve sufficiently in the investor's estimation to overcome his original preference, the transactions cost of making a switch, and any applicable tax consequences. At this point, the investor switches to the new asset.

The result of this exercise would be a theory of investors' holding periods. For any particular asset on which there was a given amount of unrealized appreciation and which was owned by an investor with a given tax rate, the holding period would be a random variable. A change in the capital gains tax rate would change the mean, and probably the other moments, of the probability distribution of holding periods.

A final step in building the theory should be to show how a given change in the probability distribution of holding periods would be translated into a change in realizations of capital gains. Presumably, a discrete shortening of the mean holding period, perhaps as a result of a cut in the capital gains tax rate, would lead to an initial surge of realizations followed by a decline to a level above the original starting point. In the long run the effect on realizations of a given shortening of the holding period will depend on the rate at which assets appreciate.[49]

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[48] See Holt and Shelton, "The Lock-In Effect of the Capital Gains Tax," and Wetzler, "Capital Gains and Losses," pp. 135–37.

With this as background, I turn to Minarik's paper. In the appendix Minarik presents historical data on realizations of capital gains and losses, but he does not use these data to draw conclusions about the effects of tax changes on realizations. For what it is worth, a simple comparison of changes in tax rates and changes in aggregate realizations of gains gives little support to those who believe that tax rates strongly influence realizations. The explicitly temporary 7.5 percent increase in capital gains tax rates from the 1968 income tax surcharge, which took effect in midyear, did not prevent a large rise in realizations in that year. The 1977 data show that realizations of net gains rose 10 percent over 1976 despite the sizable capital gains tax increase enacted in 1976 and a weak stock market. The behavior of realizations after the Tax Reform Act of 1969 is hard to interpret because that act gave investors a crazy quilt of incentives by phasing in an increase in tax rates on large gains of high-bracket taxpayers, extending and phasing out the surcharge, and enacting a minimum tax effective in 1970. Thus it is hard to evaluate the meaning of the sharp drop in realizations in 1970 or the equally sharp increases in 1971 and 1972.[50]

One interesting empirical result presented by Minarik is that a sizable number of investors make use of their flexibility about when to realize a gain to even out their income over time. It is not clear whether these taxpayers are responding to the potential tax savings resulting from this self-averaging or whether they sell assets when taxable income is low just because that is when they need the cash. In either case, Minarik's results suggest that the bunching problem is less serious than has been assumed and that, among capital gains recipients, some of the variation in the marginal tax rate applying to the first dollar of gain reflects transitory changes in income.

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[49] These calculations are relatively simple under the assumption that the holding period changes from one value to another but are considerably more difficult when an entire probability distribution of holding periods is shifting and when adjustments are made for the effect of any change in holding periods on the amount of gain passing tax-free at death.

[50] Since this paper was written, data on capital gains realized in 1979 have become available. They show a sufficient increase in realizations to make the actual revenue raised by the capital gains tax in 1979 approximately what might have been expected under the law in effect before the 1978 tax cut. This outcome is closer to the result predicted by Minarik's equation than to that predicted by Feldstein-Slemrod-Yitzhaki. The 1979 data indicate the short-run response to the tax cut, of course, not the steady-state response.

The major part of Minarik's paper is a reappraisal of Feldstein-Slemrod-Yitzhaki's highly publicized study claiming that a cut in the maximum capital gains tax rate from its 1973 level to 25 percent would lead to a threefold increase in realizations of gains. (Presumably, a cut to 25 percent from the higher 1977 tax rates would lead to a still larger increase in realizations.) The Feldstein-Slemrod-Yitzhaki study consisted of cross-section regressions relating an individual's sales of corporate stock and net gain realized on corporate stock to his marginal capital gains tax rate. The regressions were estimated from the Internal Revenue Service's 1973 study of individual transactions in capital assets.

Both Minarik and Feldstein-Slemrod-Yitzhaki should be faulted for proceeding with empirical tests without first having straightened out the relevant theory. I suspect that, once the theory of investors' holding periods and the precise link between holding periods and realizations is worked out, the system will have a reduced form in which an individual's realized gains is a dependent variable and his marginal tax rate is one of the independent variables. At that time, regressions such as those of Minarik and the earlier study may be useful in estimating some of the parameters of the system. In isolation from the relevant theory, however, their results are very hard to interpret.

For example, the short-run response of realizations to a change in the tax rate should be larger than the long-run response. Do Feldstein-Slemrod-Yitzhaki's and Minarik's coefficients measure the short-run effect, the long-run effect, or something in between? Also, a transitory decline in income affects realizations both by lowering the tax rate and by creating a need for cash. Thus if much of the variation in marginal tax rates reflects transitory changes in income, it may be impossible to get an unbiased estimate of even the short-run effect of a ceteris paribus change in tax rates.

Under these circumstances, the main contribution of Minarik's regressions is that they bring the estimated coefficient of the tax rate variable down from the stratospheric height it attained in the Feldstein-Slemrod-Yitzhaki study. The latter completely ignored the question of whether a short-run or a long-run response was being estimated. Minarik, in contrast, adds several independent variables designed to control for factors causing temporary changes in marginal capital gains tax rates in an attempt to purge the tax rate variable of transitory influences. These new variables raise the coefficient of the tax rate variable for people with medium-sized portfolios and lower it for people with large portfolios. Only for people with very large portfolios do Minarik's equations confirm Feldstein-Slemrod-Yitzhaki's conclusion that a cut in capital gains tax rates will increase realizations enough to raise revenue.

Some of Minarik's independent variables, however, probably represent something other than a measure of transitory changes in tax rates. For example, the correlation between charitable contributions and capital gains is more likely to result from the propensity of people with gains to make contributions than from the effect of contributions in temporarily lowering the marginal tax rate. It would be better to drop that variable. Business losses may affect the realization of gains not only by temporarily lowering the marginal tax rate but, more significantly, by creating a need for cash.

Problems arise in measuring the marginal capital gains tax rate. For taxpayers with capital losses or loss carry-forwards, the marginal tax rate for a capital gain is zero in the year the gain is realized; however, realization of the gain would reduce the loss carry-forward available for future years. Thus the true marginal rate for these taxpayers is the present value of the expected future tax benefit that would otherwise have been obtained from the forgone loss carry-forward. To the extent that there are errors in measuring the tax rate variable, the size of its coefficient will be biased downward.

Another issue is the quality of the underlying data. My understanding is that the 1973 capital asset tapes are of poor quality in the sense that, for many individual transactions, the reported gain does not equal the reported sale price minus the reported purchase price and that the reported total gain of many taxpayers does not equal the sum of the gains and losses from the individual transactions. I would be interested in knowing what efforts both Minarik and Feldstein-Slemrod-Yitzhaki made to deal with these problems.

I conclude from all this that we still know relatively little about the magnitude of changes in realizations, in both the short and the long run, that would result from a change in capital gains taxes. As the most promising direction for further research, I suggest more theoretical work on how holding periods are determined and how changes in holding periods are translated into changes in aggregate realizations, followed by statistical tests with the cross-sectional data to relate variation in holding periods to marginal capital gains tax rates. My guess is that a better approach to estimating the effect of tax changes on realizations will prove to be equations that use tax rates to explain variations in holding periods across individuals, rather than the variation in realizations per se.

Mr. **Minarik**. There are two effects when you change capital gains tax rates. There is a long-term effect and a short-term effect. If we increase the effective tax rate on capital gains January 1, 1987, there is not much doubt that realizations of capital gains are going to go down in the very short run.

And likewise in the past when we cut tax rates, there was not any surprise in anybody's mind that a lot of people jumped in and realized capital gains at that point. If you are holding a security and you cannot quite make up your mind whether to sell or not, and the capital gains tax rate is cut, that may very well be what you need to push you over the fence and to sell that asset. But once that asset is sold, that gain is realized and that accrued gain is no longer there to be realized.

In the longer term, after that initial burst of selling, you would expect capital gains realizations to level off, get back to where they were pretty much under the original system. It is often cited——

Senator **Boschwitz**. You would also expect in that case if there was this burst of selling that there would be new capital around to invest.

Apparently, from what I have seen, when rates go up quite high, there was not—maybe there was not a burst—as I think of the figures, there was not a burst in 1969 of increased capital gains collections. We have discussed whether or not there will be in 1986. I will sell a few things, quite frankly. But then, you know, I am going to want to invest my money somewhere. And we did not see that in the event all that money in gain was realized, we did not see that money being reinvested unless it all went into bonds. You know these guys—at least the people that I deal with—they are more venture oriented.

Mr. **Minarik**. I concur with that, Mr. Chairman. I think that what happens is that you sell some things to somebody else who sells some of his things and he may buy yours and you may buy his at the new higher basis.

Let me just reemphasize something I said earlier. What you have to look at in terms of the incentive to invest is the round trip: What does it cost, not only at the individual level but also at the corporate level, to earn a dollar of income and pay tax on it and realize it?

I would just contend, and I think it is borne out by computations that are done at the Joint Tax Committee right now, that under the current Finance Committee bill, taking into account all the taxes on capital at the Federal level and also at the State and local level, the cost of capital under this bill is lower than it is under the current law, in large part because of the substantial reduction in the corporate tax rate and the substantial reductions on capital income that is distributed in the form of dividends and interest.

Senator **Boschwitz**. Do you have any concern with some of the other stuff we were talking about—whether it is Hong Kong or Sweden or the United Kingdom or France or Germany or Italy or Japan—that capital might not flow in directions and our Tax Code has to be competitive for capital on a worldwide basis. Are you concerned that capital will flow elsewhere?

Mr. **Minarik.** Not really, Mr. Chairman. Again, you have to look at the round trip. Germany does not have a capital gains tax, but they have a periodic wealth tax, which is probably heavier.

Japan does not have a capital gains tax, but the nature of their investment markets is such that most of their firms are heavily debt financed rather than equity financed. There is not an equity market like we have here. It is just a different system overall.

Mr. **McIntyre.** One thing about Japan, by the way. It's true that they do not have a capital gains tax on profits from selling publicly traded stock. That was a provision they put in to encourage the growth of the stock market there. It did not really do much good. But on venture capital and small business stock, Japan taxes capital gains just like ordinary income, which is what the Senate bill proposes.

Mr. **Minarik.** I would just suggest, Mr. Chairman, if we have an overall tax burden on capital that is low and competitive—and let me submit that the corporate tax rate under the Senate Finance bill is going to be virtually the lowest in the world of all the developed countries—and our individual rates are going to be much lower than most other developed countries.

If the overall burden is low and if we are uniform among different uses of capital in our economy so that if the venture sector is providing the greatest rates of return, the capital flows there rather than into office buildings or other tax shelters, I think we are going to be better off in the long run.

Senator **Boschwitz.** Thank you very much.

Let me ask you before you leave, Mr. Minarik, have you ever been in business?

Mr. **Minarik.** I have never been in business. I have worked in a nonprofit sector doing economic research and I have worked at the Congressional Budget Office.

Senator **Boschwitz.** Do you invest in the stock market now and again?

Mr. **Minarik.** To the extent that I can. Not an awful lot.

Senator **Boschwitz.** Try it. You will like it.

Mr. **Minarik.** You did say you were looking for things to do with your money, Mr. Chairman.

Senator **Boschwitz.** Why? Do you have some ideas? I might do that.

Well, thank you very much.

Now we are going to have panel No. 4: Mr Lawrence Lindsey, National Bureau of Economic Research, Cambridge, MA; and also Thomas E. Vasquez, senior vice president—how do you say that?

Mr. Vasquez, how do you pronounce the name of your economic associates? DeSeve——

Mr. **Vasquez.** Actually, we are in the process of changing the name of the firm. Our new name is the Policy Economics Group.

Senator **Boschwitz.** Hit it, Mr. Lindsey.

STATEMENT OF LAWRENCE B. LINDSEY, FACULTY RESEARCH, NATIONAL BUREAU OF ECONOMIC RESEARCH, CAMBRIDGE, MA

Mr. LINDSEY. I am grateful for the opportunity to come before this committee and discuss the likely effect of changes in the tax treatment of capital gains, particularly the effects on tax revenue.

The tax reform legislation approved last month by the Senate Finance Committee contemplates eliminating the differential between capital gains and other forms of income. I would like to stress that while this proposal creates the appearance of tax equity, it is largely counterproductive from the point of view of raising tax revenue, redistributing the tax burden to upper-income taxpayers, or taxing income from different sources equally.

There are three key points I would like to make about the proposal on taxing capital gains:

First, the proposed changes will increase the tax rate on capital gains far more on middle- and lower-income taxpayers than on upper-income taxpayers.

Second, the higher tax rates proposed on capital gains income will lead to lower rates of realization and possibly less capital gains tax revenue.

Third, because the capital gains tax does not differentiate between capital gains caused by inflation and gains which actually increase a taxpayer's economic income, the effective tax rate may well be over 100 percent on real capital gains.

Mr. Chairman, popular discussion has focused on the proposed increase in the maximum capital gains tax rate from 20 percent to 27 percent. This is contemplated for a married couple with AGI over $145,000. That's a 7-percentage point increase in the rate, equivalent to a 35-percent increase.

But if I may draw your attention to table 1 at the back of my testimony, it is quite clear that lower-income taxpayers will see an even larger increase in their capital gains tax rates. Taxpayers with incomes under $50,000 will, on average, see a doubling of their capital gains tax rate and taxpayers with incomes between $30,000 and $100,000 will see an average 13 percentage point increase in their capital gains tax rates.

When one considers how much——

Senator BOSCHWITZ. Have you made any studies—pardon me, Larry.

Have you made any studies about what—is the preceding witness still around? Too bad. He had this table that showed that most of the capital gains were realized by people over $200,000 in income. I have seen some material that says 75 percent of all capital gains inured to the benefit of people in incomes over $200,000.

Do you agree with that?

Mr. LINDSEY. I do not. The 75-percent figure certainly seems high. I believe on table 2 of my testimony, there is a simulated distribution for 1988, and if I recall the numbers correctly, about a third of all capital gains are realized by taxpayers making over $200,000. I think that would be 45 out of 150, or something like that.

Senator BOSCHWITZ. I may be anticipating that. Let me——

Mr. LINDSEY. If I may also make a comment about that analysis. One reason a taxpayer appears rich is because he realizes his capital gains that year. If you built your company up from scratch—you made $50,000 a year, say, year after year after year—and finally you sell out when you are 65 to retire, and you sell the company for $300,000, you are suddenly deemed rich by this type of analysis. It is not at all clear that just because capital gains are realized by people with AGI over $200,000 that that is really typical of their lifetime income position. In fact, their lifetime income position is probably far lower than that. So I think that data exaggerates the effect.

Senator BOSCHWITZ. Interesting comment.

Mr. LINDSEY. When one considers how much these proposed changes will increase the tax rate faced by capital gains recipients as a whole, it is clear that this is the largest capital gains tax rate increase in history. On average, capital gains will be taxed at a rate 10 percentage points or 62-percent higher than they will be under current law.

Such an enormous increase in the capital gains tax rate is certain to permanently reduce the rate of capital gains realizations below what they otherwise would have been. Capital studies by numerous economists, including the preceding witness, have concluded that capital gains realizations, although not necessarily revenues, are quite sensitive to capital gains tax rates.

In a recent study I conducted at the National Bureau of Economic Research, I examined the actual behavior of capital gains recipients in different income classes over the period 1965–82, and I measured the various effects of the various provisions over that time, including alternative, maximum, and minimum tax calculations, and so forth. The results of the study showed that a 1-percentage-point increase in the capital gains tax rate reduced capital gains realizations by between 5 and 6 percent. That result did not vary much, regardless of how I ran the regressions; it all came out about the same.

The conclusion from this is that a capital gains tax rate of between 16 and 20 percent maximizes capital gains tax revenues. Consider for a moment why this is the case. When the rate goes up, the Government takes in more money on each dollar realized, but fewer dollars are realized and they lose money on the dollars not realized. When the greater tax on each dollar realized just offsets the fewer dollars realized, the capital gains tax revenue is maximized.

If we considered a capital gains tax rate of, say, 20 percent—if we increase it to 21 percent, the Government takes in 5 percent more on each dollar realized. But if the amount of gains fall by 5 percent—the amount I cited earlier—then the two effects exactly offset one another—5 percent more on each gain, but 5 percent less in gains.

This behavioral response to higher rates—that is, reduced realizations—is extremely significant in the context of the current tax bill. If you turn to table 2, it shows that the effect of the capital gains tax will be on realizations. Overall, capital gains for 1988 will fall from about $150 billion to about $90 billion, or a decrease of about 40 percent.

Now, this is such a large behavioral response that it is worth considering its plausability in light of the historic record. Between 1978 and 1979, capital gains realizations rose from $48.6 to $70.5 billion, an increase of 45 percent. That increase occurred as a result of the passage of the Steiger amendment, which reduced effective capital gains tax rates. The tax rate increase contemplated in the Senate Finance bill is far larger than the tax rate cut of 1978. Therefore, I would argue that the expected 40 percent decline is very much in line with historic experience.

Senator Boschwitz. Do you agree with the preceding witness that people may have taken some gains when the rate went down and——

Mr. Lindsey. Absolutely. I think that—again, there is a temporary effect and a permanent effect. I think we will see temporarily higher capital gains realizations at the end of this year——

Senator Boschwitz. Yes.

Mr. Lindsey [continuing]. But we will see permanently lower realizations in the long haul. And the estimate that I just gave here was a long-haul estimate, for the period after the dust settles.

Senator Boschwitz. I am going to sell.

Mr. Lindsey. OK. Sell now and buy later is the conclusion.

There are a number of ways of reducing this behavioral response. One which I simulated involved a 30-percent exclusion, similar to the current 60-percent exclusion. I estimated that realizations under such a plan would be about $139 billion, down slightly from current law, but much higher than if no exclusion were in place. The net effect on revenue would be positive. The Treasury would gain—this is an annual figure—$2.1 billion with a 30-percent exclusion, compared to no exclusion. This is because such an exclusion brings the tax bill much closer to the revenue maximizing rate between 16 and 20 percent.

I would also like to stress, Senator, that there is nothing economically optimal about revenue maximizing tax rates. All that can be said is that higher rates are totally counterproductive, because both the taxpayer and the Government lose. In fact, economic theory shows that the economically optimal tax rate is below the revenue maximizing one.

I would like to reiterate one point that Professor Minarik mentioned earlier. That is another problem with capital gains taxes. This is that they are levied on nominal income and not real income, and thus oftentimes it is only a gain due to pure inflation that is being taxed.

I picked an extreme example. Suppose I bought a thousand dollars' worth of Dow back on Inauguration Day in 1981 and there was a bull market in the meantime and low inflation. Well, it turns out, by calculations that are in the testimony, that under this bill, the effective tax rate on stock that I bought back at 1050 and sold last week at 1882, when the market was at its peak, would be 41 percent and not 27 percent. And that is under very, very fortuitous economic situations of bull market and low inflation.

If I bought that stock 10 years ago, the inflation we have had over those 10 years would exactly cancel out the 93-percent rise in the Dow. I would be subject to $251 in capital gains tax on every thousand dollars of my initial investment, even though I had no real capital gains after the 10 years of inflation.

A careful study by Feldstein and Slemrod of 1973 income tax returns shows that this was very typical, and that on net people had negative real, that is after inflation, capital gains on which they were paying taxes.

Well, a lower tax rate on capital gains or a partial exclusion of nominal capital gains from tax can be justified as a partial, though not a perfect remedy for this taxation of inflationary gains. It is important to realize, however, that there is no theoretical justification for taxing capital gains at the same rate as ordinary income, unless some inflation adjustment is made as well.

In conclusion, therefore, the proposed treatment of capital gains under the Senate Finance bill cannot be justified on the basis of either economic efficiency or equity. It imposes the largest tax rate increase on capital gains at the bottom and middle of the income distribution, not at the top. It is likely to cost the Treasury money, rather than raise revenue. And finally, it will not advance the fair and equitable taxation of economic income, which is the main impetus behind tax reform.

Thank you.

Senator Boschwitz. Let me ask you the same question I asked the other—not to be contentious, but have you ever been in business?

Mr. Lindsey. No, I have not. I have been employed in the government and as an academic.

Senator Boschwitz. You come up with vastly different conclusions than the other——

Mr. Lindsey. Yes, I suppose we do.

Senator Boschwitz. And the National Bureau of Economic Research—is that a nonprofit type of——

Mr. Lindsey. Yes, it is a nonprofit organization that was founded back in the twenties and——

Senator Boschwitz. Was it? I thought that it——

Mr. Lindsey. It is a nonprofit organization.

Senator Boschwitz. All right.

[The prepared statement of Mr. Lindsey follows:]

CAPITAL GAINS TAX RATES AND TAX REVENUES

Testimony by

Lawrence B. Lindsey

before the

Senate Small Business Committee

June 4, 1986

Washington, D.C.

Lawrence B. Lindsey is an Assistant Professor of Economics at Harvard University and a Faculty Research Fellow at the National Bureau of Economic Research. He was formerly Senior Staff Economist for Tax Policy at the Council of Economic Advisers. The views expressed in this testimony are his own and not those of Harvard or NBER.

I am grateful for the opportunity to come before this committee to discuss the likely effect of changes in the tax treatment of capital gains, and particularly the effects of these changes on capital gains tax revenue.

The tax reform legislation approved last month by the Senate Finance Committee contemplates eliminating the differential between the tax rate on capital gains and the rate on other forms of income. While this proposal creates the appearance of tax equity, it is largely counterproductive from the point of view of raising tax revenue, redistributing the tax burden to upper income taxpayers, or taxing income from different sources equally.

There are three key points to make about the proposed changes in the tax treatment of capital gains:

o The proposed changes will increase the tax rate on capital gains far more on middle income taxpayers than on upper income taxpayers.

o The higher tax rates proposed on capital gains income will lead to lower rates of realizations of capital gains and less capital gains tax revenue.

o Because the capital gains tax does not differentiate between capital gains caused by inflation and gains which actually increase a taxpayer's economic income, the effective tax rate on real capital gains may actually be in excess of 100 percent under the proposed legislation.

I will elaborate on each point in turn.

Popular discussion has focussed on the proposed increase in the maximum capital gains tax rate from 20 to 27 percent. This is the contemplated increase for a married couple with Adjusted Gross Income in excess of $175,000. This 7 percentage point increase in the rate is equivalent to a 35 percent increase.

Lower income taxpayers will see an even larger increase in their capital gains tax rate. Taxpayers with incomes under $50,000 will, on average, see a doubling of their capital gains tax rate. Taxpayers with incomes between $30,000 and $100,000 will see an average 13 percentage point increase in their capital gains tax rate.

(These data are presented in Table 1 at the end of this text. They were computed using the National Bureau of Economic Research TAXSIM model, which, like the Treasury Tax Calculator, relies on a large stratified random sample of actual tax returns. The computations are for 1988 and are tabulated by AGI class using the current definition of AGI. The calculations assume the tax rate schedule and other provisions of the Senate Finance Committee bill are fully phased in and that no special provisions are made for capital gains.)

When one considers how much the proposed changes will increase the tax rate faced by capital gains recipients as a whole, it is clear that this is the largest capital gains tax rate increase in history. On average, capital gains will be taxed at a rate 10 percentage points or 62 percent higher than they would be under current law.

Such an enormous increase in the capital gains tax rate is certain to permanently reduce the rate of capital gains realizations below what they otherwise would have been. Careful studies by numerous economists[1] have concluded that capital gains realizations are quite sensitive to capital gains tax rates.

In a recent study I conducted at the National Bureau of Economic Research, I examined the actual behavior of capital gains recipients in different income classes over the period 1965-1982. I made careful measurement of the tax rates faced by these groups and included the various alternative, maximum, and minimum tax calculations which affected capital gains over the period. The results of the study showed that a 1 percentage point increase in the capital gains tax rate decreased capital gains realizations by between 5 and 6 percent. A wide variety of econometric specifications were used and all produced roughly the same result.[2]

The conclusion from this research was that a capital gains tax rate of between 16 and 20 percent maximized capital gains tax revenue. Let us consider why this is the case. When the capital gains tax rate goes up, the government collects more money on each dollar of capital gains realized. This increases tax revenue. But, when the tax rate goes up, fewer dollars of capital gains are realized, which tends to reduce the revenue collected. Where these two effects exactly offset one another is where tax revenue is maximized.

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1) For example: Gerald Auten, Gerry Brannon, Charles Clotfelter, Martin Feldstein, Joseph Minarik, Joel Slemrod, and Shlomo Yitzhaki

2)For a more detalied analysis, see: Capital Gains: Rates, Realizations, and Revenues, NBER Working Paper #1893

Consider a capital gains tax rate of 20 percent. If we increase it to 21 percent, the government takes in 5 percent more money on each dollar of capital gains. If the higher capital gains tax rate reduces the amount of capital gains by 5 percent, the two effects exactly offset one another, and no additional revenue is raised.

The behavioral response to higher rates -- reduced realizations -- is extremely significant in the context of the current bill. Table 2 shows the effect of the capital gains tax rate increase on realizations. Overall, capital gains realizations will fall from about $150 billion to about $90 billion, a decline of 40 percent.[3] This lower level of realizations will in turn reduce capital gains tax receipts by $15.6 billion below what would occur if there were no behavioral response.

This is such a large behavioral response it is worth considering its plausibility in light of the historic record. Between 1978 and 1979 capital gains realizations rose from $48.6 billion to $70.5 billion, an increase of 45 percent. That increase occurred as a result of the passage of the Steiger Amendment which reduced the effective capital gains tax rate by increasing the exclusion and ending the adverse effects of the additional minimum and maximum taxes on capital gains. The tax rate increase contemplated in the Senate Finance Bill is far larger than the tax rate cut of 1978. The expected 40 percent decline is therefore very much in line with historical experience.

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3) These simulations used the NBER TAXSIM model. An elasticity of realizations to the after capital gains tax share kept by the taxpayer (1 minus the tax rate) of 4.2 was used. This was estimated in NBER Working Paper 1893 and is consistent with a 1 percentage point increase causing a 5-6 percent reduction in realizations at current capital gains tax rates.

There are a number of ways of reducing this behavioral response and increasing tax revenue. One, which I have simulated would involve a 30 percent exclusion of capital gains from AGI similar to the current 60 percent exclusion. I estimate that realizations under such a plan would be about $139 billion, down slightly from current law, but much higher than if no exclusion were in place. The net effect on revenue would be positive, a gain of $2.1 billion compared with no exclusion. Such an exclusion brings the tax bill much closer to the revenue maximizing range of 16 to 20 percent.

It is important to stress that there is nothing economically optimal about revenue maximizing tax rates. All that can be said about higher rates is that they are counterproductive -- both the government and the taxpayer lose out. In fact, economic theory shows that the economically optimal tax rate is below the revenue maximizing one.

An additional problem with high capital gains tax rates is that the tax base on which they are levied does not reflect the true economic income of the recipient, but to a large extent simply represents inflationary gains. Consider an example. Suppose I had the foresight to buy $1000 worth of the Dow Jones Average back in January, 1981, when the Dow was at 1050, and taken advantage of both the low inflation and booming market since then, selling at last week's closing high of 1582. My $1000 would have become $1800, and I would pay capital gains tax of $216 at a 27 percent rate, leaving me with a $584 profit. But, because of the 27 percent cumulative inflation over this period, I need $1270 just to break even. My real profit after inflation is only $530, and the effective tax rate on my real capital gain is 41 percent, not 27 percent.

The recent bull market and low inflation is atypical. Had I bought stock 10 years ago, in 1976, the 93 percent inflation over the period would have just cancelled out the 93 percent increase in the Dow. On a $1000 initial investment I would have to pay $251 in capital gains tax (at a 27 percent rate) on $930 of pure inflation. I would thus be paying taxes even though I had no real income. A careful study by Feldstein and Slemrod of 1973 tax returns showed that on net, people paid capital gains taxes even though they had negative real capital gains income.

A lower tax rate on capital gains or partial exclusion of capital gains income from tax can be justified as a possible, though imperfect remedy for this taxation of inflation. It is important to realize that there is no theoretical justification for taxing capital gains at the same rate as ordinary income unless some inflation adjustment is also made.

In conclusion therefore, the proposed treatment of capital gains under the Senate Finance bill cannot be justified on grounds of either economic efficiency or equity. It imposes the largest tax rate increase on capital gains at the bottom and in the middle of the income distribution, not at the top. It is likely to cost the Treasury money, rather than raise revenue. And finally, it will not advance the fair and equitable taxation of economic income, which is the main impetus behind tax reform.

Thank you.

Table 1

Weighted Average Capital Gains Tax Rates

Income Class	Current Rate	Proposed Rate	Change in Rate	Percent Change
under 10	3.9	11.1	7.2	+ 185%
10 - 20	8.6	21.4	12.8	+ 148%
20 - 30	11.7	21.5	9.8	+ 84%
30 - 40	11.7	24.0	12.3	+ 105%
40 - 50	13.3	27.0	13.7	+ 103%
50 - 75	16.4	29.4	13.0	+ 79%
75 - 100	17.3	30.3	13.0	+ 75%
100 - 200	18.7	28.0	9.3	+ 50%
over 200	20.0	26.7	6.7	+ 34%
Overall	16.1	26.0	9.9	+ 62%

Lawrence B. Lindsey

Table 2

Capital Gains Rates and Realizations Under Senate Finance Bill

Income Class	1988 Capital Gains Realizations No Response	 With Response	Revenue Lost Due To Response
under 10	8.0	5.0	- 0.6
10 - 20	9.5	5.2	- 0.8
20 - 30	13.3	8.4	- 1.1
30 - 40	8.6	4.7	- 0.9
40 - 50	8.2	4.1	- 1.2
50 - 75	17.1	8.8	- 2.5
75 - 100	10.8	5.4	- 1.8
100 - 200	18.8	11.5	- 2.1
over 200	55.1	38.1	- 4.6
Overall	149.5	91.0	-15.6

Lawrence B. Lindsey

Senator BOSCHWITZ. Dr. Vasquez.

STATEMENT OF DR. THOMAS E. VASQUEZ, PRESIDENT, POLICY ECONOMICS GROUP, WASHINGTON, DC

Dr. VASQUEZ. Thank you, Mr. Chairman. It is a pleasure to be here today. I am here to discuss two narrow issues in this current debate, the revenue effect and the distributional effect of changing capital gains taxes. There is obviously a great deal of confusion over the revenue effects of the Senate Finance Committee bill as relates to capital gains.

There are newspaper reports of a $220 billion revenue effect. At this hearing one Senator indicated a $70 billion loss in revenues, Mr. Minarik stated that we need capital gains in order to pay for the tax reform in the bill. The confusion is understandable since the Joint Committee on Taxation does not separately identify the revenue effects of capital gains in the revenue tables for the Senate Finance Committee bill.

At this point there is not a publicly available revenue estimate on the effect of the capital gains change.

Senator BUMPERS. What were the capital gains collections—in 1983 I think there were $12.9 billion, as I recall.

Dr. VASQUEZ. We are estimating that in 1986 capital gain revenues will be about $20 billion.

I am going to make a very brief statement. But I would like to introduce for the record a longer paper that I prepared for the Coalition of American Entrepreneurship.

Senator BOSCHWITZ. Yes.

[Subsequent information was received and follows:]

THE EFFECT OF PROPOSED CAPITAL GAINS TAX RATE INCREASES ON FEDERAL INDIVIDUAL INCOME TAX REVENUES

Submitted to:

The Coalition for American Entrepreneurship

by:

deSeve Economics Associates

May, 1986

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Executive Summary

This report presents an analysis of the expected revenue impact of proposed changes in the taxation of individual capital gains. The report analyzes the capital gains tax provisions in both the Tax Reform Act of 1985, as reported by the House, and the President's tax reform proposal submitted to the Congress in May 1985. The House bill would increase the maximum individual capital gains tax rate from 20 percent under current law to 22 percent beginning in 1986. The President's proposal would reduce the maximum rate from 20 percent to 17.5 perent. At issue is whether these rate changes would have a significant effect on federal tax revenues.

The analysis is based in large part on results from a U.S. Treasury Department study of the effects of changes in capital gains tax rates. In the Treasury study, it is concluded that recently enacted reductions in the capital gains tax rate (the Revenue Act of 1978 and the Economic Recovery Act of 1981) induced "unlocking" of accrued, but unrealized gains, that (1) generated significant revenue increases over the short-run; and (2) resulted in relatively small revenue increases or decreases in years subsequent to the transition period.

In this report, the analysis of the proposed changes in capital gains taxation are disaggregated into three effects. The first two- (1) individual tax rate schedule changes; and (2) a reduction in the capital gains exclusion rate- are considered under the static assumption that realizations are not affected by tax rate changes. The third effect is the change in realizations induced by changes in the capital gains tax rate.

Using the relationships between realizations and tax rates estimated in the Treasury study, it is projected that in response to the increase in the capital gains tax rate proposed in the

House bill, taxpayers will reduce realizations to such a degree that 99 percent of the static revenue increase will be offset over the five-year budget period. As shown in Table 1, the House bill results in a diminimus revenue impact--$0.2 billion--for the period 1986-90. Similarly, the report shows that the light capital gains tax rate reduction (from 20 to 17.5 percent) proposed by the President results in a negligible revenue effect over the same five-year period.

This report also uses the Treasury study to distinguish between short-run, or transition period, effects of changes in capital gains taxation and the subsequent longer-run effects. Table I shows that for the first three years after taking effect, the House bill rate increase will actually lower capital gains tax revenues. Annual revenue increases are not expected until four years after the rate increase. Similarly, the tax rate reductions in the President's proposal would increase capital gains tax revenues in the first three years. It should be noted that the further in the future estimates are projected, the less certain they become as the empirical evidence on which they are based becomes less robust and the underlying assumptions relating to the state of the economy become more speculative.

Table I

Net Effect of the Tax Reform Provisions on Tax Revenues from Capital Gains

($ billions)

	Year					Cumulative
House Bill	1986	1987	1988	1989	1990	1986 - 1990
Static Effect:						
Individual Rate Schedule Changes	-0.3	-1.5	-2.5	-2.8	-3.1	-10.2
Exclusion Rate Changes	0.9	4.3	6.3	7.1	7.8	26.4
Total, Static Effect	0.6	2.8	3.8	4.3	4.7	16.2
Induced Effect 1/	-0.7	-3.1	-4.2	-3.8	-4.2	-16.0
Net Effect	-0.1	-0.3	-0.4	0.5	0.5	0.2

	Year					Cumulative
President's Proposal	1986	1987	1988	1989	1990	1986 - 1990
Static Effect:						
Individual Rate Schedule Changes	-0.3	-1.7	-2.9	-3.2	-3.6	-11.8
Exclusion Rate Changes	0.3	1.3	2.2	2.4	2.7	8.9
Total, Static Effect	*	-0.4	-0.7	-0.8	-0.9	-2.9
Induced Effect	0.1	0.5	0.9	0.7	0.8	2.9
Net Effect	0.1	0.1	0.2	-0.1	-0.1	*

1/ Treasury and the Joint Committee on Taxation include induced effects in their estimates of the revenue effects of capital gains rate changes, but their estimates of the magnitude of these effects may differ somewhat from the magnitude shown above.

Note: Details may not add to totals due to rounding.

* Less than $50 million

INTRODUCTION

The Congress is currently considering the Tax Reform Act of 1985 (H.R. 3838) which was reported by the House Ways and Means Committee on December 7, 1985. This legislation was the initial Congressional response to the tax reform proposals submitted to the Congress by The President in May 1985. Among the many proposed changes in the House bill, this legislation would increase the maximum individual income tax rate on long-term capital gains from 20 percent under current law to 22 percent in 1986 and 22.04 percent thereafter.

Revenue neutrality and distributional neutrality are considered by policymakers to be key to the passage of tax reform legislation. As such, estimates of the revenue impact of each provision within the bill are important for economic and political evaluation of the legislation. If the proposal to increase capital gains tax rates rests on the assumption that additional tax revenues will be generated to offset partial revenue losses from other proposals, the basis of this assumption must be carefully examined.

The difficulty in determining the impact of changes in capital gains taxation on revenue stems primarily from two provisions of the tax code: first, capital gains are taxed only when realized rather than as they are accrued; second, capital gains may avoid taxation altogether when assets are transferred at death. Because realization of accrued gains is discretionary, these provisions allow taxpayers to defer or avoid taxation of gains. In deciding how long to hold an asset, taxpayers take into account the taxes that will be incurred upon realization. The accepted theory is that higher tax rates induce taxpayers to hold capital assets for longer periods of time. In estimating the revenue effects of tax rate changes, it is this "lock-in" effect that is difficult to quantify.

This report presents an analysis of the expected revenue effect of the capital gains proposal in the House bill and the President's tax reform proposal based on evidence from changes in capital gains tax rates in recent years. Section I provides a summary of historic and proposed changes in the Federal tax code treatment of capital gains. Section II summarizes the analysis and findings of a recent comprehensive study by the U.S. Treasury Department on the effects of changes in the capital gains tax. In Section III, revenue estimates for the individual capital gains provisions of the House bill are derived. The estimates are based, in part, on the results from the recent Treasury study. For comparison, revenue estimates for the individual capital gains provisions of President Reagan's tax reform proposal are derived in Section IV. Section V presents a description of the methodology used by the Treasury Department and the Joint Committee on Taxation in estimating the effects of the proposal.

I. HISTORIC AND PROPOSED CHANGES IN CAPITAL GAINS TAXATION

Historic Changes

Table 1 shows the maximum capital gains tax rate for each year since 1954. This time span can be divided into three distinct periods with regard to capital gains taxation. Between 1954 and 1969, capital gains tax rates remained virtually constant. Over the entire period, long-term assets were defined as those held for at least six months. Taxpayers had the option of excluding 50 percent of long-term gains from ordinary income and taxing the remaining 50 percent at ordinary rates,1/ or taxing all of their long-term gains at a flat 25 percent alternative rate. The only change in the maximum capital gains tax rate over this

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1/ Prior to 1964, the maximum tax rate on ordinary income was 91 percent. As as result of the Kennedy tax cuts, the rate was phased to 70 percent by 1965.

Table 1

Maximum Marginal Tax Rates on Long-Term Capital Gains, 1954 to Present 1/

Year	Percentage
1954 - 1967	25.0%
1968	26.9
1969	27.5
1970	32.2
1971	30.8
1972 - 1975	45.5
1976 - 1978 2/	49.1
1979	28.0
1980	28.0
1981 3/	20.0
1982	20.0
1983	20.0
1984	20.0
1985	20.0
1986 4/	20.0

Source: Report to Congress on the Capital Gains Tax Reductions of 1978, Office of the Secretary of the Treasury, Office of Tax Analysis. September 1985, Table 1.13.

1/Includes the ordinary tax, alternative tax, minimum tax, alternative minimum tax, maximum tax, and surcharge.

2/Through October 31, 1978

3/After June 9, 1981

4/Current Law

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period resulted from the Vietnam War surcharge, which raised the maximum rate from 25 percent to 26.9 percent in 1968 and 27.5 percent in 1969.1/

Between 1970 and 1978, there was a significant increase in the tax rate on capital gains. First, the 25 percent alternative tax that had applied to all long-term gains was limited to the first $50,000 of gains. Remaining long-term gains were taxed at rates up to 29.5 percent in 1970, 32.5 percent in 1971, and 35 percent (one-half of the maximum tax rate on ordinary unearned income) thereafter. Second, a 10 percent minimum tax on the "excluded" portion of capital gains in excess of a theshhold became effective in 1970. In 1976, this minimum tax rate was increased to 15 percent and the threshold amount was lowered. Third, changes in the capital gains rates were indirectly affected by changes in the tax on earned income. The maximum tax on earned income was lowered from 70 percent to 60 percent in 1971 and to 50 pecent beginning in 1972. However, excluded gains in excess of $30,000 reduced, on a dollar for dollar basis, the amount of earnings eligible for taxation at the lower rate. The $30,000 floor was eliminated in 1976, and all excluded gains contributed to the so-called "poisoning" of the maximum tax. The net effect of these three changes was to increase the maximum capital gains rate to 49 percent by 1978. (See Appendix A for calculation) In addition, the holding period required for assets to be considered long-term was raised to nine months in 1977 and to one year in 1978.

Since 1978, capital gains tax rates have been significantly reduced. The Revenue Act of 1978: 1) raised the long-term gains exclusion rate from 50 percent to 60 percent for assets sold after

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1/ The surcharge increased ordinary tax rates and the alternative tax rate by 7.5 percent in 1968, and by 10 percent in 1969.

November 1, 1978; 2) repealed the 25 percent alternative tax; 3) repealed the poisoning effect of excluded gains on the maximum tax; 4) repealed the treatment of excluded gains as a preference item for the minimum tax; and 5) imposed an alternative minimum tax of up to 25 percent on an income base that included all long-term capital gains. The net effect of the 1978 Act was to reduce the maximum capital gains rate to 28 percent beginning in 1979. The Economic Recovery Tax Act of 1981 (ERTA) further lowered the top rate on capital gains to 20 percent for assets sold after June 9, 1981. During this period there were other changes that affected capital gains taxes (but not the maximum gains rate), including the across-the-board reductions of the 1978 Act and ERTA; changes in the alternative minimum tax calculations enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA); and the reduction in the holding period for long-term assets to six months enacted in the Deficit Reduction Act of 1984.

Proposed Changes

There are three major aspects of the House bill that affect the capital gains tax rates: 1) the overall change in the tax rate schedule, which lowers the top rate on ordinary income to 38 percent; 2) the reduction in the capital gains exclusion rate from 60 percent under current law to 50 percent in 1986 and 42 percent in 1987 and subsequent years; and 3) changes in the alternative minimum tax rate consistent with the lower top rate on ordinary income and the lower exclusion rate.

In addition, this bill has other provisions that relate to the capital gains treatment of certain assets. The bill phases out the special capital gain rules for coal and domestic iron ore royalties. It extends the recapture provisions that currently apply to intangible drilling costs to depletion deductions and mining, exploration and development costs with respect to oil, gas, and geothermal property. The bill also repeals the present law capital gains treatment as it relates to gains from timber grown on Federal lands. (Furthermore, there is a phase-out of timber capital gains treatment for corporations.) Although these provisions have both revenue effects and economic consequences on particular industries, analysis of these specific provisions is beyond the scope of this report.

II. THE TREASURY DEPARTMENT STUDY

The Treasury Department recently published a study of the revenue impact of changes in capital gains taxes that resulted from the 1978 Act and from ERTA.1/ Two different methodologies were used to estimate their impacts. The first was based on a cross-section of individual income tax return data; the second was based on aggregate time series data. The two approaches, as well as the conclusions drawn from the Treasury study, are discussed below.

Cross-section Analysis

Similar to previous work in this area,2/ the cross-section approach examines the relationship between capital gains realized by each taxpayer and various taxpayer attributes, including income, wealth, age, and the effective capital gains tax rate the individual faces under current law. The relationship between realizations and these variables is statistically estimated based on a sample of individual income tax returns.

1/ Report to Congress on the Capital Gains Tax Reductions of 1978, Office of the Secretary of the Treasury, Office of Tax Analysis, September, 1985.

2/ See Martin S. Felstein, Joel Slemrod, and Shlomo Yitzhaki, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains," Quarterly Journal of Economics, June 1980; and Gerald E. Auten and Charles T. Clotfelter, "Permanent Versus Transitory Tax Effects and the Realization of Capital Gains," Quarterly Journal of Economics, November, 1982.

The Treasury then uses these results to simulate realization levels under three tax law structures--1978 law (pre-1978 Act), 1979-80 law (post-1978 Act, pre-ERTA), and 1984 law (post-ERTA). The estimated sensitivity of realizations to tax rate changes is summarized in Table 2. These results, derived from the Treasury study, are presented in terms of the elasticity of capital gains realizations with respect to capital gains tax rates for different income classes. The elasticities approximate the percentage change in realizations that result from a percentage change in tax rates.

The table shows that elasticities are negative for all but the lowest income class, which indicates that reductions in tax rates induce additional realizations of capital gains at nearly every income level. The table also shows that the overall elasticity for both the 1978 and 1981 tax rate reductions is in excess of unity. This means that the static revenue loss associated with a reduction in capital gains tax rates is more than offset by the behavioral response to increase realizations and that the tax rate reductions yield an increase in Federal tax revenues.

Time-series Analysis

The second approach examines the relationship between the aggregate level of annual capital gains realizations and effective marginal tax rates on gains, corporate stock holdings, and general economic variables since 1954. Forecasts for 1979-82 are derived based on this historical relationship and actual financial and economic conditions observed in these years. These forecasts indicate what revenue would have been in 1979-82 if tax law had not changed. The differences between this forecast and actual realizations is attributed to legislated changes in the tax rate.

Table 3 shows the elasticity of realizations with respect to tax rate changes derived from the time series analysis in the

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Table 2

Elasticities of Capital Gains Realizations with Respect to Tax Rates on Capital Gains, Distributed by Adjusted Gross Income Class

(1979 Levels of Income)

Adjusted Gross Income Class ($1,000's)	The Revenue Act of 1978	ERTA 1981
Less than 10	0.4	-2.8
10 - 15	-1.1	-1.4
15 - 20	-1.0	-1.2
20 - 30	-1.1	-1.1
30 - 50	-1.1	-1.0
50 - 100	-1.4	-1.6
100 - 200	-1.6	-1.7
200 or More	-2.1	-1.9
Total, All Classes	-1.7	-1.7

Source: These elasticities are derived from Report to Congress on the Capital Gains Tax Reductions of 1978, Office of the Secretary of the Treasury, Office of Tax Analysis, September 1985, Tables 4.5, 4.6, 4.8 and 4.9.

Table 3

Elasticities of Capital Gains Realizations with Respect to Tax Rates on Capital Gains Derived from the Treasury Time-Series Analysis of the 1978 Act and ERTA

Calendar Year	The Revenue Act of 1978	ERTA
1979	-1.8	na
1980	-1.3	na
1981	-1.1	-0.8
1982	-1.0	-0.9

na - Not Applicable

Note: The figures are derived from Report to Congress on the Capital Gains Tax Reductions of 1978, Office of the Secretary of the Treasury, Office of Tax Analysis, September 1985; Tables 4.14 and 4.15.

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Treasury study. These results show that the 1978 Act led to: 1) significant "unlocking" of gains and corresponding revenue increases in the first year (indicated by an elasticity significantly greater than unity in 1979) and, 2) little or no change in revenue in the next three years (indicated by nearly unitary elasticities). The slightly less than unitary elasticities derived for the ERTA rate reductions indicate that the induced realizations did not completely offset the revenue losses from the rate reduction.

In summary, the two approaches generally show that the capital gains rate reductions induced "unlocking" of accrued, but unrealized, gains to a degree sufficient to offset the effect of lower tax rates in the first year, thereby creating revenue increases. The extent to which the revenue effect in subsequent years is positive or negative is ambiguous, with the cross-section and time-series analyses producing conflicting results. However, both approaches lead to the conclusion that if there is a revenue loss resulting from the capital gains rate reductions, it is relatively small.

The Treasury study is perhaps the most comprehensive to date, but important questions about the permanent or transitory nature of these impacts remain unanswered. To the extent that the rate reductions accelerated unlocking of gains that would have eventually been taxed, there would be an expected large transition period effect on realizations over one or more years. However, the long-run increase in realizations resulting from the shorter holding period for capital assets woud be small.

Following an approach used by Martin Bailey, if the average holding period for all assets is reduced by a full year in response to a tax rate reduction, realizations would be expected to increase by only 5 percent, given a 10 percent annual rate of accrual.1/ To the extent that the rate cuts induce realization of accrued gains that would have otherwise occured only in the context of a nontaxable step-up in basis (gains passed as death), one would expect a more significant permanent increase in the level of realizations. The degree to which the elasticity exceeds unitary in the cross-section analysis indicates that this may have been the case with the 1978 and 1981 reductions. In addition, the time series elasticities indicate that, at least through 1982, there was little adverse effect on revenues. Because the study does not go beyond 1982, there is no further quantitative evidence of the long-run effect.

The Treasury study does not attempt to use its findings to simulate other potential changes in capital gains taxes. The nearness of the elasticities to unity, however, leads to the conclusion tht small rate changes--either increases or decreases--would be expected to have a negligible long-run impact on Federal tax revenues.

III. THE REVENUE EFFECT OF THE PROPOSED CHANGES IN CAPITAL GAINS TAXATION - HOUSE BILL

The overall revenue impact of the proposed changes in capital gains taxation reflects three component parts: 1) the effect of tax rate schedule changes (estimated under the static assumption that realizations are not affected by tax rate changes); 2) the effect of the reduction in the exclusion rate (estimated under the same static assumption); and 3) the effect of changes in realizations induced by the changes in capital gains taxation.

1/ The ratio of realizations to accurals can be determined by the equation:

$$\frac{(1+R) - (1+R)}{RT}(1-T)$$

Where r is the annual rate of accrual and t is the holding period in years. See Martin J. Bailey, "Capital Gains and Income Taxation", in Martin J. Bailey, The Taxation of Income from Capital.

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For each of these components, three calculations are performed: (a) estimates are derived from a sample of tax returns at calendar year 1986 levels of income; (b) the effect on taxpayers' tax liabilities at current income levels is estimated for calendar years 1986-90; and (c) the effects on Federal income tax revenues are estimated for fiscal years 1986-90.

The Individual Income Tax Rate Schedule Changes

Under current law, taxpayers filing joint returns fall into one of fourteen taxable income brackets and are taxed at marginal rates ranging from 11 to 50 percent. Because 40 percent of capital gains (net long-term gain in excess of net short-term loss) must be included in taxable income, capital gains tax rates currently range from 4.4 percent (.4 x 11 percent) to 20 percent (.4 x 50 percent). Taxes on capital gains are calculated indirectly by first simulating individuals' overall tax liability and then simulating their tax liability on income other than capital gains. The difference is the tax liability on capital gains income. The ratio of capital gains taxes to capital gains realizations is the effective capital gains tax rate.

Table 4 reports average tax rates on net long-term capital gains by adjusted gross income class at 1986 levels of income under current 1986 tax law. The overall average rate on gains of 14.3 percent is substantially below the 20 percent maximum rate.

The House bill proposes to collapse the number of taxable income brackets to four, with tax rates ranging from 15 to 38 percent beginning July 1, 1986. To effect this mid-year starting date, the 1986 rates would be exactly half-way between the current law rates and the proposed rates for 1987 and subsequent years. These rates, therefore, range from 13 to 44 percent. With no change in the capital gains exclusion rate, the tax rates on capital gains under the House bill would range from 5.2 percent

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Table 4

Current Law Average Tax Rate on Net Long-term Capital Gains, Distributed by Adjusted Gross Income Class 1/

(1986 Levels of Income; 1986 Law)

Adjusted Gross Income ($1,000's)	Percent
Less than 10	3.9%
10 - 15	3.6
15 - 20	4.5
20 - 30	5.8
30 - 50	8.5
50 - 100	13.1
100 - 200	18.0
200 or more	19.8
Total	14.3%

1/For returns with net gains in adjusted gross income

(.4 x 13 percent) to 17.6 percent (.4 x 44 percent) in 1986 and from 6 percent (.4 x 15 percent) to 15.2 percent (.4 x 38 percent) in subsequent years.

Tax liability under the House bill rates (again assuming no change in the exclusion rate) is simulated using these tax rate schedules, and corresponding alternative minimum tax rates of 17.6 percent in 1986 and 15.2 percent in 1987.[1] The difference between the proposed law tax liability simulated 1) for all income and 2) for income other than capital gains, reflects the tax liability for capital gains under the proposed rate schedule. The ratio of capital gains tax liability under proposed rates to capital gains realizations is the effective tax rate on capital gains under the proposed rate schedule. These results, which assume the same level of realizations assumed in Table 4, are shown on Table 5. As under current law, the 12.9 percent average tax rate on gains under the House bill is below the maximum rate.

The difference between capital gains taxes calculated under proposed tax rates and capital gains taxes calculated under current tax rates is the "static" effect of the proposed change in capital gains tax rates, i.e. the amount of tax that would be lost to the Treasury if there were no induced effect on realizations.

The static effects of the proposed tax rate reductions on fiscal year tax revenues for fiscal years 1986-90 are summarized in Table 6. Based on the growth in capital gains over the last several years, current law capital gains are estimated to rise to

1/ In addition, the simulation of the House bill includes other major proposals to revise the Tax Code. The major changes are in the personal exemption, standard deduction, second earner deduction, miscellaneous and employee business expense deductions, and dividend exclusion. In calculating tax liability, these changes affect the tax bracket and tax rate each individual faces; therefore, they indirectly affect the tax rate on capital gains. The estimate of this indirect effect is included in the estimated impact of individual tax rate schedule changes on capital gains taxes.

Table 5

Average Tax Rate on Net Long-Term Capital Gains Under the Individual Tax Rate Schedule Changes Included in the House Tax Reform Bill 1/

(assuming no change in realizations
and no change in the exclusion rate)

(1986 levels of income)

Adjusted Gross Income ($1,000's)	1986 Rate Schedule	1987 Rate Schedule
Less than 10	3.5%	3.1%
10 - 15	3.0	2.9
15 - 20	3.9	3.8
20 - 30	5.3	5.2
30 - 50	7.9	7.5
50 - 100	12.4	11.9
100 - 200	17.1	16.3
200 or more	18.8	18.2
Total	13.5%	12.9%

1/For returns with net gains in adjusted gross income

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Table 6

Calculation of the Change in Fiscal Year Revenues from Capital Gains Taxes Due to the Proposed Changes in Individual Income Tax Rates
(assuming no change in realizations)

($ billions)

	Year					Cumulative
	1986	1987	1988	1989	1990	1986 - 1990
Net Long-Term Gains, Calendar Year	154.0	174.0	196.6	216.3	244.4	985.3
Tax Rate on Net Long-Term Gains: (%)						
Under Current Law	14.3	14.3	14.3	14.3	14.3	
Under the Proposed Rate Schedule	13.5	12.9	12.9	12.9	12.9	
Change	-0.8	-1.4	-1.4	-1.4	-1.4	
Change in Calendar Year Tax Liabilities on Capital Gains Assuming No Change in Realizations	-1.2	-2.4	-2.8	-3.0	-3.4	-12.9
Change in Fiscal Year Tax Receipts from Capital Gains Taxes Assuming No Change in Realizations	-0.3	-1.5	-2.5	-2.8	-3.1	-10.3

Note: Details may not add to totals due to rounding.

$154 billion in 1986, and continue to increase at a 13 percent annual rate thereafter. Multiplying these current law levels of capital gains realizations by the percentage point reduction in the average capital gains tax rate-- -0.8 percent for 1986 and -1.4 percent thereafter-- yields the static estimate of the reduction in tax liabilities for calendar years 1986-90. From these results, the effect on fiscal year individual income tax receipts is then calculated. The cumulative static effect of the proposed tax rate change is a $10.3 billion reduction in tax revenues from capital gains through fiscal year 1990. It should be noted that because taxes on capital gains are collected on a less timely bases than taxes on wages other than income, it is assumed that only 25 percent of the current year tax liability change will be reflected in current fiscal year Federal revenues.1/ The remaining 75 percent of the liability change will be reflected in revenues in the following fiscal year.

Capital Gains Exclusion Rate Changes

Under the House bill, the exclusion rate is lowered from 60 to 50 percent in 1986 and to 42 percent thereafter. The remaining portion is taxed according to the proposed schedule of rates on ordinary income. The tax rate on gains, therefore, ranges from 6.5 percent (.5 x 13 percent) to 22 percent (.5 x 44 percent) in 1986, and from 8.7 percent (.58 x 15 percent) to 22.04 percent percent (.58 x 38 percent) thereafter. The alternative minimum tax rate on capital gains is correspondingly changed to 22 percent. Proposed law tax liability is again simulated but this time with the proposed exclusion rate and alternative minimum tax rate taken into account.

1/The Deficit Reduction Act of 1984 (DEFRA) subjected tax liability accruing from the alternative minimum tax to the declarations and estimated tax payment requirements that apply to regular individual income taxes. Therefore, taxes on capital gains are collected on a more timely schedule currently than they were before this change. The estimates derived here for fiscal year revenue effects account for the DEFRA change.

The static effect of the reduction in the exclusion rate is computed at 1986 levels of income as the difference between the estimates of (1) tax liability resulting from this simulation, which uses both the proposed exclusion rate and the proposed tax rates, and (2) tax liability resulting from the simulation, described above, that held the exclusion at the current law 60 percent rate but incorporated the proposed tax rates. Table 7 reports the change in tax as a percent of the 1986 level of capital gains realizations.

Table 8 reports the derivation of the estimated static effect of the proposed change in the exclusion rate on fiscal year tax revenues. The impact of the change in the exclusion rate on current year tax liabilities is estimated for calendar years 1986-90 from the anticipated realization levels under current law (reported on Table 6) and the change in tax as a percent of the realization levels that result from the change in the exclusion rate (shown on Table 7). Again assuming that 25 percent of the calendar year impact is realized in the current fiscal year and 75 percent in the subsequent fiscal year, the effect on fiscal year revenues is then calculated. Table 8 shows that the proposed reduction in the exclusion rate would result in a cumulative revenue increase of $26.4 billion over the period 1986-90, again assuming that the level of realizations is unaffected by changes in tax rates.

Induced Effects

The change in capital gains realizations induced by the tax law changes is calculated on the basis of estimates of the sensitivity of realizations to tax rate change (derived in the Treasury study) and estimates of the change in average tax rates that would result from implementation of the proposals. The average tax rate on gains under current law was derived in Section 1 and reported in Table 4. The tax rate on gains under the full House proposal

Table 7

Change in Tax Liability as a Percent of Realizaions Due to Reducing the Exclusion Rate as Proposed in the House Tax Reform Bill

(assuming no change in realizations)1/

(1986 levels of income)

Adjusted Gross Income ($1,000's)	1986 Exclusion (50%)	1987 Exclusion (42%)
Less than 10	*%	0.4%
10 - 15	1.6	2.9
15 - 20	2.3	3.7
20 - 30	2.1	3.4
30 - 50	2.1	3.7
50 - 100	2.7	4.4
100 - 200	3.1	4.3
200 or more	2.9	3.6
Total	2.4%	3.5%

*Less than .05 percent

1/For returns with net gains in AGI

Table 8

Calculation of the Change in Fiscal Year Revenues Due to a Change in the Capital Gains Exclusion Rate as Proposed in the House Tax Reform Bill

(assuming no change in realizations)1/

($ billions)

	Year					Cumulative
	1986	1987	1988	1989	1990	1986 - 1990
Net Long-Term Gains, Calendar Year	154.0	174.0	196.6	216.3	244.4	985.3
Change in Tax Liability Due to Proposed Change in the Exclusion Rate as a Percent of Realizations (%)	2.4	3.5	3.5	3.5	3.5	
Change in Tax Liability Due to Proposed Change in the Exclusion Rate, Assuming No Change in Realizations	3.7	6.1	6.9	7.6	8.6	32.8
Change in Fiscal Year Receipts Due to Proposed Change in the Exclusion Rate, Assuming no Change in Realizations	0.9	4.3	6.3	7.1	7.8	26.4

Note: Estimates are based on the proposed law tax rate schedule.
Details may not add to totals due to rounding.

1/Proposal reduces exclusion rate to 50% in 1986 and 42% thereafter.

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is simulated taking into account the proposed changes in the exclusion rate, tax rate schedules, and the alternative minimum tax.[1/] The average tax rate on capital gains is reported by income class in Table 9. The proposed changes in the House bill would increase the tax rate on capital gains in each income class, and the overall rate increases by about 15 percent from 14.3 percent to 16.4 percent in 1987.

Table 10 shows the elasticities derived from the Treasury cross-section study of rate changes in ERTA that are used to estimate the transition period tax effects of changes in realizations resulting from the proposed increase in tax rates in the House bill.[2/] For each income class, the percentage decrease in realizations is derived as the product of these elasticities and the percentage increase in the capital gains tax rate implicit in the proposals. The overall elasticity approximates the ratio of the percentage change in realizations for all income classes to the percentage change in the average effective tax rate. The implicit -1.3 elasticity of realizations with respect to tax rates indicates that the lock-in effect of the increased tax rate more than offsets the higher tax rates and leads to lower tax liability.

[1/] Again, the average tax on gains under the House bill is estimated indirectly as the difference between the tax liability for (1) all income, and (2) for income other than capital gains. These simulations differ from those in Section I in that they include both the proposed rate schedules and the proposed exclusion rate (and the corresponding 22 percent alternative minimum tax rate); the Section I calculations accounted for only the proposed rate schedules. As before, these simulations include the effects of other major Tax Reform proposals (See footnote 7).

[2/] The elasticities used here are not equal to those shown in Table 2. The statistical relationship between gains and tax rates estimated in the Treasury study is not a constant elasticity specification, i.e., a different elasticity applies at each different tax rate. The elasticities used here were calculated directly from the predicting equation derived in the Treasury study.

Table 9

Proposed Tax Rate on Net Long-Term Capital Gains Under the House Tax Reform Bill, Distributed by AGI Class

(assuming no change in realizations)1/

(1986 levels of income)

Adjusted Gross Income ($1,000's)	Proposed 1986 Law	Proposed 1987 Law
Less than 10	3.5%	3.6%
10 - 15	4.6	5.8
15 - 20	6.2	7.5
20 - 30	7.4	8.6
30 - 50	10.0	11.2
50 - 100	15.1	16.3
100 - 200	20.1	20.6
200 or more	21.8	21.8
Total	15.9%	16.4%

1/For returns with net gains in AGI.

Table 10

Elasticities of Realizations With Respect to Tax Rate Changes Included in the House Bill, Distributed by AGI Class 1/

(1986 levels of income)

Adjusted Gross Income ($1,000's)	Current Law Tax Rate (percent)	1986 Law		1987 Law	
		Proposed Law Tax Rate (percent)	Elasticities of Realizations with Respect to Tax Rate Changes	Proposed Law Tax Rate (percent)	Elasticities of Realizations with Respect to Tax Rate Changes
Less than 10	3.9	3.5	-2.6	3.6	-2.6
10 - 15	3.6	4.6	-1.2	5.8	-1.3
15 - 20	4.5	6.2	-1.1	7.5	-1.1
20 - 30	5.8	7.4	-1.0		
8.6	-1.6				
30 - 50	8.5	10.0	-0.9	11.2	-0.9
50 - 100	13.1	15.1	-1.5	16.3	-1.5
100 - 200	18.0	20.1	-1.7	20.6	-1.7
200 or more	19.8	21.8	-1.9	21.8	-1.9
Total	14.3	15.9	-1.1	16.4	-1.3

1/For returns with net gains in AGI.

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Consistent with the Treasury time-series results, it is assumed that this revenue loss is only a transitory effect. For the longer run, it is assumed that realizations will be lower under proposed law than under current law, but that the resulting revenue loss will not completely offset the revenue increases that result from the higher tax rates. Based on the Treasury time-series analysis results (reported on Table 3), the elasticity of realizations with respect to the proposed tax rate change would be expected to fall to less than unity after the first year the rates are in effect.

Table 11 shows the estimated changes in revenues induced by changes in realizations for fiscal years 1986-90. These revenue effects are calculated in several steps. First, the change in realizations at current calendar year income levels is estimated using elasticities of realizations with respect to changes in the tax rates that decline from -1.1 in 1986 and -1.2 in 1987 (half-way between the transitional elasticity calculated above and unitary) to -0.9 in 1988 through 1990. The percentage change in realizations is calculated as a product of the percentage change in the capital gains tax rate and the elasticity of realizations with respect to the change in the capital gains tax rate.[1] Induced changes in current year tax liabilities are then derived for 1986-90 by multiplying the change in realizations by the proposed tax rate on gains. Finally, fiscal year receipts are then calculated for 1986-90 assuming, as before, that 25 percent of the change in the tax liability of each calendar year results in a change in revenues in the same fiscal year and that the remaining 75 percent occurs in the subsequent fiscal year.

Estimates of the static and induced effects of the proposed capital gains tax changes are summarized in Table 12. The table

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[1] These calculations are performed in logs, so that the percentage change in realizations differs somewhat from the product of the precentage change in tax rates and the assumed elasticities shown in Table 11.

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Table 11

Calculation of the Change in Fiscal Year Receipts Due to Changes in Capital Gains Realizations Induced by the House Tax Reform Bill

($ billions)

	Year					Cumulative
	1986	1987	1988	1989	1990	1986 - 1990
Net Long-Term Gains	154.0	174.0	196.6	216.3	244.4	985.3
Tax Rate on Capital Gains (%)						
Current Law	14.3	14.3	14.3	14.3	14.3	
Proposed Law	15.9	16.4	16.4	16.4	16.4	
Percentage Change	11.2	14.7	14.7	14.7	14.7	
Elasticity of Realizations with Respect to Changes in Tax Rates	-1.1	-1.2	-.9	-.9	-.9	
Percentage Change in Realizations (%)	-11.0	-15.2	-11.6	-11.6	-11.6	
Change in Realizations	-17.0	-26.4	-22.8	-25.1	-28.4	-119.6
Change in Tax Liability	-2.7	-4.3	-3.7	-4.1	-4.7	-19.5
Change in Fiscal Year Receipts	-.7	-3.1	-4.2	-3.8	-4.2	-16.0

Note: Details may not add to totals due to rounding.

Table 12

Net Effect of the House Tax Reform Bill on Tax Revenues from Capital Gains

($ billions)

	Year 1986	1987	1983	1989	1990	Cumulative 1986 - 1990
Static Effect:						
Individual Rate Schedule Changes	-0.3	-1.5	-2.5	-2.8	-3.1	-10.2
Exclusion Rate Changes	0.9	4.3	6.3	7.1	7.8	26.4
Total, Static Effect	0.6	2.8	3.8	4.3	4.7	16.2
Induced Effect	-0.7	-3.1	-4.2	-3.8	-4.2	-16.0
Net Effect	-0.1	-0.3	-0.4	0.5	0.5	0.2

Note: Details may not add to totals due to rounding.

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shows that the cumulative net revenue effect of the proposed increase in tax rates on capital gains is negligible ($0.2 billion) over the five- year period, 1986-90. This reflects the fact that virtually all of the revenue effect estimated under static assumptions is offset when induced changes in realizations are taken into account.

IV. REVENUE EFFECT OF THE PROPOSED CHANGES IN CAPITAL GAINS TAXATION--PRESIDENT'S TAX REFORM PROPOSAL

The tax reform proposal submitted by President Reagan to the Congress in May 1985 includes proposals that would reduce the maximum tax rate on individual capital gains from 20 percent to 17.5 percent. The two major aspects of the package that affect capital gains tax rates are 1) an overall change in the tax rate schedule, which lowers the top rate on ordinary income to 35 percent; and 2) a reduction in the capital gains exclusion rate from 60 percent under current law to 50 percent. These changes, if enacted as proposed, would take effect beginning July 1, 1986.[1]

Unlike the House bill, the President's proposal would not provide changes in the alternative minimum tax rate consistent with the lower top rate on ordinary income and the lower exclusion rate, but would retain the current law rate of 20 percent. The President's proposal does include provisions to restructure the computation of the alternative minimum tax.[2]

1/The President's tax reform proposal also includes a provision allow indexing of capital gains beginning in 1991. Under this provision taxpayers are allowed a basis adjustment for inflation after January 1, 1991 in lieu of the exclusion. Because indexing is proposed to be optional on the part of taxpayers, this provision, if enacted, would further reduce the tax rate on nominal capital gains for many taxpayers.

2/In addition, this proposal has other provisions that relate to the capital gains treatment of certain assets. It disallows the capital gains preference for depreciable and depletable assets used in a trade or business, thereby treating the gain from sale of those assets in the same manner as the income from sale of other business property. The proposal also disallows special capital gains treatment currently afforded by section 1231 of the Code to interests in timber, coal, iron ore, livestock, and unharvested crops. Analysis of these provisions is beyond the scope of this report.

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As described in Chapter III relating to the House bill, the overall revenue impact of the President's capital gains proposal can be divided into three effects: 1) the static effect of the tax rate schedule changes; 2) the static effect of the exclusion rate reduction; and 3) the effect of changes in realizations induced by the changes in capital gains taxation. As for the House bill, for each of these components, calculations are performed to estimate: (a) changes in tax liabilities derived from a sample of tax returns at 1986 levels of income; (b) changes in taxpayers' tax liabilities at current income levels for calendar years 1986-90; and (c) changes in Federal income tax revenues for fiscal years 1986-90.

The Individual Income Tax Rate Schedule Changes

The President's tax reform proposals would collapse the number of taxable income brackets to three, with tax rates ranging from 15 to 35 percent beginning July 1, 1986. To effect this midyear starting date, the 1986 rates would be exactly halfway between the current law rates and the proposed rates for 1987 and subsequent years. These rates, therefore, range from 13 to 42.5 percent. With no change in the capital gains exclusion rate, the tax rates on capital gains under the President's proposal would range from 5.2 percent (.4 x 13 percent) to 17 percent (.4 x 42.5 percent) in 1986 and from 6 percent (.4 x 15 percent) to 14 percent (.4 x 35 percent) in subsequent years. Tax liability under the President's proposed rates (again assuming no change in the exclusion rate) is simulated using these tax rate schedules.[1/] The difference between the proposed law tax liability simulated 1) for all income and 2) for income

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1/In addition, the simulation of the president's tax reform proposal includes other major proposals to revise the tax code. The major changes are in the personal exemption, standard deduction, second earner deduction, state and local tax deductions, miscellaneous and employee business expense deductions, alternative minimum tax, and dividend exclusion. In calculating tax liability, these changes affect the tax bracket and tax rate each individual faces; therefore, they indirectly affect the tax rate on capital gains. The estimate of this indirect effect is included in the estimated impact of individual tax rate schedule changes on capital gains taxes.

indirectly affect the tax rate on capital gains. The estimate of this indirect effect is included in the estimated impact of individual tax rate schedule changes on capital gains taxes.

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other than capital gains, reflects the tax liability for capital gains under the rate schedule proposed by the President. The ratio of capital gains tax liability under proposed rates to capital gains realizations is the effective tax rate on capital gains under the rate schedule proposed by the President. These results are shown in Table 13.

Assuming no induced changes in realizations, the change in capital gains taxes resulting from the individual tax rate reductions proposed by the President is calculated as the difference between capital gains taxes calculated under the proposed tax rate schedule and capital gains taxes calculated under the current law tax rate schedule. Table 14 reports the derivation of the estimated static effect of the proposed tax rate reductions on fiscal year tax revenues. The impact of the tax rate schedule changes on current year capital gains tax liabilities is estimated for calendar years 1986-90 from the anticipated realization levels under current law (reported in Table 6) and the percentage point reductions in the average capital gains tax-- -0.9 percent for 1986 and -1.6 percent thereafter. From these results, the effect on fiscal year individual income tax receipts is then calculated assuming, as in the House bill analysis, that 25 percent of the calendar year impact is realized in the current fiscal year and 75 percent in the subsequent fiscal year. The cumulative static effect of the proposed tax rate change is an $11.8 billion reduction in tax revenues from capital gains through fiscal year 1990.

Capital Gains Exclusion Rate Changes

Under the President's tax reform package, the exclusion rate is lowered to 50 percent for assets sold after 1986. The proposal is not specific as to the exclusion rate that applies to assets sold in 1986. Because the effective date of the change is July 1, 1986, it is assumed that gains on all capital assets sold

Table 13

Average Tax Rate on Net Long-Term Capital Gains Under the Individual Tax Rate Schedule Changes Included in the President's Tax Reform Proposal 1/

(assuming no change in realizations
and no change in the exclusion rate)

(1986 levels of income)

Adjusted Gross Income ($1,000's)	1986 Rate Schedule	1987 Rate Schedule
Less than 10	3.7%	3.6%
10 - 15	3.6	3.6
15 - 20	4.9	4.9
20 - 30	5.6	5.6
30 - 50	8.0	7.6
50 - 100	12.1	11.3
100 - 200	16.8	15.8
200 or more	18.6	17.8
Total	13.4%	12.7%

1/For returns with net gains in adjusted gross income

Table 14

Calculation of the Change in Fiscal Year Revenues from Capital Gains Taxes Due to the Proposed Changes in Individual Income Tax Rates for the President's Tax Reform Package

(assuming no change in realizations)

($ billions)

	Year					Cumulative
	1986	1987	1988	1989	1990	1986 - 1990
Net Long-Term Gains, Calendar Year	154.0	174.0	196.6	216.3	244.4	985.3
Tax Rate on Net Long-Term Gains: (%)						
Under Current Law	14.3	14.3	14.3	14.3	14.3	
Under the Proposed Rate Schedule	13.4	12.7	12.7	12.7	12.9	
Change	-0.9	-1.6	-1.6	-1.6	-1.6	
Change in Calendar Year Tax Liabilities on Capital Gains Assuming No Change in Realizations	-1.4	-2.8	-3.1	-3.5	-3.9	-14.7
Change in Fiscal Year Tax Receipts from Capital Gains Taxes Assuming No Change in Realizations	-0.3	-1.7	-2.9	-3.2	-3.6	-11.8

Note: Details may not add to totals due to rounding.

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at any time during 1985 are subject to a 55 percent exclusion rate (averaging the proposed 50 percent and current 60 percent rates). The remaining portion is taxed according to the proposed schedule of rates on ordinary income. The tax rate on gains, therefore, ranges from 5.85 percent (.45 x 13 percent) to 19.13 percent (.45 x 42.5 percent) in 1986, and from 7.5 percent (.5 x 15 percent) to 17.5 percent (.5 x 35 percent) thereafter. The alternative minimum tax rate is 20 percent as under current law. Proposed law tax liability is again simulated but this time with the proposed exclusion rate taken into account.

The static effect of the reduction in the exclusion rate is computed at 1986 levels of income as the difference between the estimate of (1) tax liability resulting from this simulation, which uses both the exclusion rate and the tax rate schedules proposed by the President, and (2) tax liability resulting from the simulation, described above, that held the exclusion at the current law 60 percent rate but incorporated the tax rate schedules proposed by the President. Table 15 reports the change in tax as a percent of the 1986 level of capital gains realizations.

Table 16 reports the derivation of the estimated static effect of the proposed change in the exclusion rate on fiscal year tax revenues. The impact of the change in the exclusion rate on current year tax liabilities is estimated for calendar years 1986-90 from expected realization levels under current law (reported in Table 6) and the change in tax as a percent of the realization levels that result from the change in the exclusion rate to 50 percent (reported in Table 15). Again assuming that 25 percent of the calendar year impact is realized in the current fiscal year and 75 percent in the subsequent fiscal year, the effect on fiscal year revenues is then calculated. Table 16 shows that the proposed reduction in the exclusion rate would result in a cumulative revenue increase of $8.9 billion over the

Table 15

Change in Tax Liability as a Percent of Realizaions Due to Reducing the Exclusion Rate as Proposed in the President's Tax Reform Package

(assuming no change in realizations)1/

(1986 levels of income)

Adjusted Gross Income ($1,000's)	1986 Exclusion (55%)	1987 Exclusion (50%)
Less than 10	0.1%	0.1%
10 - 15	0.5	1.1
15 - 20	0.8	1.3
20 - 30	0.8	1.5
30 - 50	0.8	1.6
50 - 100	1.0	1.8
100 - 200	1.1	1.7
200 or more	0.6	0.9
Total	0.7%	1.2%

1/For returns with net gains in AGI

Table 16

Calculation of the Change in Fiscal Year Revenues Due to a Change in the Capital Gains Exclusion Rates as Proposed in the President's Tax Reform Package

(assuming no change in realizations)1/

($ billions)

	Year					Cumulative
	1986	1987	1988	1989	1990	1986 - 1990
Net Long-Term Gains, Calendar Year	154.0	174.0	196.6	216.3	244.4	985.3
Change in Tax Liability Due to Proposed Change in the Exclusion Rate as a Percent of Realizations (%)	0.7	1.2	1.2	1.2	1.2	
Change in Tax Liability Due to Proposed Change in the Exclusion Rate, Assuming No Change in Realizations	1.1	2.1	2.4	2.6	2.9	11.1
Change in Fiscal Year Receipts Due to Proposed Change in the Exclusion Rate, Assuming no Change in Realizations	0.3	1.3	2.2	2.4	2.7	8.9

Note: Estimates are based on the proposed law tax rate schedule.
Details may not add to totals due to rounding.

1/Proposal reduces exclusion rate to 55% in 1986 and 50% thereafter.

period 1986-90 under the static assumption that the level of realizations is unaffected by changes in tax rates.

Induced Effects

As described in Chapter III relating to the House bill, the change in capital gains realizations induced by tax law changes is calculated using estimates of the sensitivity of realizations to tax rate changes and estimates of the change in average tax rates that would result from implementation of the proposals. The tax rate on gains under the President's tax reform proposal is simulated taking into account the proposed changes in the tax rate schedules and exclusion rate. The average tax rate on capital gains resulting from this simulation is reported by income class in Table 17. Compared to the current law average capital gains tax rates derived in Section 1 and reported in Table 4, the President's proposals reduces the tax rate on capital gains in each income class over $100,000 and the overall rate falls by about 3 percent from 14.3 percent to 13.9 percent in 1987.

Table 18 reports the the elasticities derived from the Treasury cross-section study of rate changes in ERTA that are used to estimate the transition period tax effects of changes in realizations resulting from the implicit tax rate changes proposed by the President. The overall -1.6 elasticity of realizations with respect to tax rates calculated for 1987 indicates that the unlocking effect of the reduced tax rate more than offsets the lower tax rates and leads to higher tax liability.

In analyzing the revenue impact of the House bill, it was assumed, based on the Treasury time-series study, that the estimated revenue loss resulting from the lock-in effect of higher tax rates is largely transitory. For the longer run, it

Table 17

Proposed Tax Rate on Net Long-Term Capital Gains Under the President's Tax Reform Package, Distributed by AGI Class

(assuming no change in realizations)[1]

(1986 levels of income)

Adjusted Gross Income ($1,000's)	Proposed 1986 Law	Proposed 1987 Law
Less than 10	3.8%	3.7%
10 - 15	4.1	4.6
15 - 20	5.6	6.2
20 - 30	6.4	7.0
30 - 50	8.8	9.2
50 - 100	13.1	13.2
100 - 200	17.9	17.5
200 or more	19.2	18.7
Total	14.1%	13.9%

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[1] For returns with net gains in AGI.

Table 18

Elasticities of Realizations With Respect to Tax Rate Changes Included in the President's Tax Reform Package, Distributed by AGI Class 1/

(1986 levels of income)

Adjusted Gross Income ($1,000's)	Current Law Tax Rate (percent)	1986 Law		1987 Law	
		Proposed Law Tax Rate (percent)	Elasticities of Realizations with Respect to Tax Rate Changes	Proposed Law Tax Rate (percent)	Elasticities of Realizations with Respect to Tax Rate Changes
Less than 10	3.9	3.8	-2.7	3.7	-2.6
10 - 15	3.6	4.1	-1.2	4.6	-1.3
15 - 20	4.5	5.6	-1.1	6.2	-1.1
20 - 30	5.8	6.4	-0.9	7.0	-1.0
30 - 50	8.5	8.8	-0.9	9.2	-0.9
50 - 100	13.1	13.1	-1.5	13.2	-1.5
100 - 200	18.0	17.9	-1.7	17.5	-1.7
200 or more	19.8	19.2	-1.9	18.7	-1.9
Total	14.3	14.1	-1.4	13.9	-1.6

1/For returns with net gains in AGI.

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was assumed that higher tax rates will offset lower realizations levels and result in revenue increases. Similarly, it is expected that under the President's proposal, longer-run realizations will be higher than under current law, but that the resulting revenue increase will not completely offset the revenue losses that result from lower tax rates.

Table 19 shows the estimated changes in revenues induced by changes in realizations for fiscal years 1986-90. The calculations used to derive these revenue effects follow the steps described in Chapter III relating to the House bill. First, the change in realizations at current calendar year income levels is estimated using elasticities of realizations with respect to changes in tax rates that decline from -1.4 in 1986 and -1.3 in 1987 (half-way between the transitional elasticity calculated above and reported in Table 18, and unitary) to -0.9 in 1988 through 1990. The percentage change in realizations is calculated as approximately a product of the percentage change in the capital gains tax rate and the elasticity of realizations with respect to the change in the capital gains tax rate. Induced changes in current year tax liabilities are then derived for 1986-90 by multiplying the change in realizations by the proposed tax rate on gains. Finally, fiscal year receipts are calculated for 1986-90 assuming, as before, that 25 percent of the change in the tax liability of each calendar year results in a change in revenues in the same fiscal year and that the remaining 75 percent occurs in the subsequent fiscal year.

Estimates of the static and induced effects of the President's proposals to change capital gains tax rates are summarized in Table 20. The table shows that the cumulative net effect of the proposed increase in tax rates on capital gains is negligible over the five-year period 1986-90. That is to say that when the effect of induced realizations is taken into account, all of the revenue loss of the President's proposal estimated under static assumptions is offset.

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Table 19

Calculation of the Change in Fiscal Year Receipts Due to Changes in Capital Gains Realizations Induced by the President's Tax Reform Package

($ billions)

	Year					Cumulative
	1986	1987	1988	1989	1990	1986 - 1990
Net Long-Term Gains	154.0	174.0	196.6	216.3	244.4	985.3
Tax Rate on Capital Gains (%)						
Current Law	14.3	14.3	14.3	14.3	14.3	
Proposed Law	14.1	13.9	13.9	13.9	13.9	
Percentage Change	-1.4	-2.8	-2.8	-2.8	-2.8	
Elasticity of Realizations with Respect to Changes in Tax Rates	-1.4	-1.3	-.9	-.9	-.9	
Percentage Change in Realizations (%)	2.0	3.8	2.6	2.6	2.6	
Change in Realizations	3.1	6.5	5.1	5.6	6.3	26.6
Change in Tax Liability	0.4	0.9	0.7	0.8	0.9	3.7
Change in Fiscal Year Receipts	0.1	0.5	0.9	0.7	0.8	2.9

Note: Details may not add to totals due to rounding.

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Table 20

Net Effect of the President's Tax Reform Package on Tax Revenues from Capital Gains

($ billions)

	Year					Cumulative
	1986	1987	1988	1989	1990	1986 - 1990
Static Effect:						
Individual Rate Schedule Changes	-0.3	-1.7	-2.9	-3.2	-3.6	-11.8
Exclusion Rate Changes	0.3	1.3	2.2	2.4	2.7	8.9
Total, Static Effect	*	-0.4	-0.7	0.8	-0.9	-2.9
Induced Effect	0.1	0.5	0.9	0.7	0.8	2.9
Net Effect	0.1	-0.1	0.2	-0.1	-0.1	*

Note: Details may not add to totals due to rounding.

* Less than $50 million

V. TREASURY AND JOINT COMMITTEE ON TAXATION METHODS AND ESTIMATES

Neither the Treasury Department's Office of Tax Analysis nor the Joint Committee on Taxation have released official revenue estimates associated with the proposed changes in capital gains taxation included in the House bill. (The Joint Committee has published revenue estimates for the House bill; however, effects of changes in the capital gains tax rate are included with estimates of overall changes in individual income tax rates.)[1] The methods employed by the Treasury and the Joint Committee to estimate the revenue effects of the proposed increases in capital gains taxation, however, are similar to those described above. In each case, the estimating process accounts for an offsetting impact of induced changes in realization levels. Each methodology produces the result that in the first year the proposal takes effect, higher tax rates on gains yield lower tax revenues. Furthermore, each methodology takes into account an induced lock-in of realizations in subsequent years but not enough to offset the increases in revenues from higher tax rates, i.e., an elasticity less than unity (but greater than zero in absolute value).

The major difference among the estimates lies in the extent to which the elasticity between realizations and tax rates is assumed to be less than unity after the transitional period. The Joint Committee/Treasury models appear to use somewhat lower elasticities of realizations to tax rate changes than shown in Table 11 and to result in cumulative revenue gains from the House bill of about $1 to $3 billion over the five-year period 1986-90. This represents an anticipated increase in taxes on capital gains of 1 to 2 percent generated from an average tax rate increase of about 15 percent, from 14.3 percent to 16.4 percent, as shown earlier on Table 10.

[1] See House of Representatives: "Tax Reform Act of 1985, Report of the Committee on Ways and Means House of Representatives on H.R. 3838 Together with Dissenting and Additional Dissenting Views" (Rept. 99-426), December 7, 1985.

Neither the Treasury nor the Joint Committee include an induced effect in their respective analyses of the distributional impact of the House bill (although they do include induced effects in their revenue estimates). To the extent that the long-run elasticity of realizations with respect to the tax rate on gains is close to zero, exclusion of the induced effect will not be of great significance. However, if lock-in induced by higher rates is maintained in the long-run, the omission will result in a less accurate allocation of tax liability by income class. This follows from the fact that the overwhelming share of capital gains is realized by upper income individuals. If the lock-in efect is ignored, income will be overestimated, and, therefore, high income individuals will appear to have larger tax liabilities than they in fact have.

The effect of the lock-in on the distribution of tax liability under the House bill is demonstrated in an example reported in Table 21. Under the assumption that realizations are not affected by the tax rate change, individuals in the $10,000- $20,000 income class incur 2.0 percent of total tax liability, while individuals with income over $200,000 pay 52.2 percent. If the transition period lock-in of capital gains induced by the proposal is taken into account, the share of taxes paid by individuals in the $10,000-$20,000 class falls to 1.4 percent, and the share for individuals in the over $200,000 class increases to 54.1 percent. Because distributional effects are important in the decision making process, such differences have significance.

Similarly, the effect of unlocking on the distribution of tax liability under the President's proposal is shown in an example reported in Table 22. When the transition period unlocking of realizations is taken into account, the share of taxes paid by individuals in the $10,000 - 20,000 income class falls from 2.0 to 1.3 percent, and the share for individuals in the over $200,000 class increases from 52.8 to 55.5 percent.

Table 21

Percent Distribution of Tax Liability on Capital Gains Under Current Law and the House Tax Reform Bill, Assuming Changes in Realizations Induced by Change in Tax Rates 1/ Distributed by AGI Class

(1985 Levels of Income, 1987 Transition Period Effects)

Adjusted Gross Income ($1,000's)	Current Law Tax Liability	Proposed Law Tax Liability (1987 Law)	
		Assuming No Change in Realizations	Assuming Change in Realizations1/
		Percentage Distribution	Percentage Distribution
Less than 10	2.8%	2.3%	3.5%
10 - 15	0.6	0.8	0.6
15 - 20	0.8	1.2	0.8
20 - 30	2.1	2.8	2.3
30 - 50	6.4	7.3	7.1
50 - 100	12.1	13.2	11.6
100 - 200	20.4	20.3	20.0
200 or more	54.6	52.2	54.1
Total	100.0%	100.0%	100.0%

Note: Details may not add to totals due to rounding.

1/Using the transition period elasticities for the 1987 tax increase shown on Table 10.

Table 22

Percent Distribution of Tax Liability on Capital Gains Under Current Law and the President's Tax Reform Proposal, Assuming Changes in Realizations Induced by Change in Tax Rates 1/ Distributed by AGI Class

(1986 Levels of Income, 1987 Transition Period Effects)

Adjusted Gross Income ($1,000's)	Current Law Tax Liability	Proposed Law Tax Liability (1987 Law)	
		Assuming No Change in Realizations	Assuming Change in Realizations1/
		Percentage Distribution	Percentage Distribution
Less than 10	2.8%	2.8%	3.0%
10 - 15	0.6	0.8	0.5
15 - 20	0.8	1.2	0.8
20 - 30	2.1	2.7	2.1
30 - 50	6.4	7.1	6.3
50 - 100	12.1	12.5	11.7
100 - 200	20.4	20.3	20.1
200 or more	54.6	52.8	55.5
Total	100.0%	100.0%	100.0%

Note: Details may not add to totals due to rounding.

1/Using the transition period elasticities for the 1987 tax increase shown on Table 18.

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CONCLUSION

The tax reform proposals passed by the House include provisions that effectively increase the tax rate on capital gains. Using the results from a Treasury Department study of the relationship between capital gains and tax rates, this report shows that the static revenue increase resulting from this tax rate increase will be almost entirely offset by lower realization levels. It should be noted that these estimated effects pertain only to tax rate increases of the magnitude being proposed. Efforts to generate substantial revenue from further capital gains rate increases, thereby offsetting the ERTA and 1978 Act rate reductions, would probably be ineffective as more and more gains lock-in in response to the higher tax rates. Similarly, reductions in the capital gains tax rate from 20 percent to 17.5 percent could be expected to result in negligible revenue losses, because increased realizations would largely offset the effect of the rate reductions.

APPENDIX A

This takes into account only the ordinary tax, alternative tax, poisoning of the maximum tax on earned income, and minimum tax and is calculated as follows:

Ordinary or alternative tax =
Maximum tax schedule rate x Capital gains inclusions
= 70% x 50% = 35%

Poisoning of the maximum tax =
Capital gains exclusion x (Maximum tax schedule rate - Maximum rate on earned income)
= 50% x (70% - 50%) = 10%

Regular tax =
Ordinary or alternative rate + Poisoning of the maximum tax
= 35% + 10% = 45%

Minimum tax =
Minimum tax rate x (Capital gains exclusion - one half regular tax)
= 15% x (50% - .5 x 45%) = 4.1%

Total tax = Regular tax + Minimum tax
= 45% + 4.1% = 49.1%

Dr. VASQUEZ. My basic conclusion is that there is an insignificant revenue effect from changing capital gains tax rates within the range of the tax rates that we are talking about here, either in the Senate Finance bill, the President's proposal or the House bill.

I am estimating a revenue gain of $1.9 billion over the 5-year period from the Senate Finance bill. I have used conservative assumptions. I would not be surprised at all if the revenue effect was zero or negative. But it cannot be possible for the number to be higher than $1.9 billion. That seems to me inconceivable.

I would like to point out that I am not a novice at revenue estimating. I was the Deputy Director of the Office of Tax Analysis, U.S. Treasury Department, and headed the revenue estimating staff. I was also on the revenue estimating staff of the Joint Committee on Taxation.

I unfortunately was also the person in 1978 who estimated a revenue loss from the capital gains change in Congressman Steiger's bill, and I have learned my lesson.

Senator BOSCHWITZ. I was not going to say anything. [Laughter.]

Dr. VASQUEZ. I thought you were going to ask me so I wanted to get it out.

Senator BOSCHWITZ. That and other estimates around here have been very wide off the mark. However, frankly, I presume that if I had been making the estimates, they would have been wide off the mark, as well.

Dr. VASQUEZ. I think missing the sign of the revenue estimate is always very embarrassing. It was a revenue gain and I estimated a loss. The reason we dramatically misestimated the revenue effect is that I did not believe the research that was available at the time primarily by Mr. Feldstein and Mr. Slemrod, the same researchers that Mr. Lindsey just mentioned. The result was that I dramatically underestimated the realization effect of that tax rate change.

It is a very straightforward process to estimate the static revenue effect of a tax law change like capital gains. My firm has a file of actual income tax returns and a computer simulation model has each taxpayer prepare his tax return to reviewing his tax payments. We simply changed the capital gains tax rate and calculated the change in revenue. This is a "static" estimate however and does not allow for any behavioral response by the taxpayer. The $70 billion revenue gain that was mentioned this morning is a "static" estimate. A calculation assumes no one changes their behavior. That is not too different from what we did in 1978. Luckily at that time the budget constraints were not such that it prevented the bill from being enacted. In the current environment, however, it is obviously of very critical importance.

The theory on behavior response as Mr. Lindsey has described, is very straightforward. Capital gains taxes are a transaction cost and to the extent that you lower transactions cost, people are more likely to sell their assets and realize capital gains. The issue is just what is the exact response.

We did not reestimate the behavioral response. Rather, we used the Treasury study, the study of the 1978 capital gains change. They calculated an elasticity of 1.7, which means that if you increase the tax rate on capital gains by 10 percent, you would expect to have a 17-percent reduction in realizations. This produces a revenue loss because realizations have gone down more than the tax rate went up by.

I used this elasticity for every taxpayer. The Policy Economics Groups has a data file of about 300,000 tax returns and computer software. This system is modeled after the system that the Treasury Department and the Joint Committee on Taxation uses. So I am basically using exactly the same file with exactly the same procedures and very similar behavior responses. I say that mainly to point out that my guess is that the Treasury Department, if asked to produce a revenue estimate, would produce one very similar to mine.

If I could just conclude by referring to table 1 in my testimony. I show the static and induced revenue effect for three different tax proposals: The President's proposal, the House bill, and finally the Senate Finance Committee bill.

Under the President's proposal which reduces the capital gains top rate from 20 to 17.5 percent, I show a zero revenue loss in the period 1986 through 1990. The static effect is a revenue loss of $2.9 billion, but the induced effect is a revenue gain of $2.9 netting to zero.

Under the Senate Finance Committee bill, the static effect from the exclusion rate change itself would raise $77.5 billion over the 5-year period. I assume that that was the number that the Senator was referring to this morning.

However, that is the static revenue effect and does not have the effective induced realizations. The effect on revenues of induced realizations would be to lower revenues by $65.7 billion for a net effect over the 5-year period of $1.9 billion.

Seventy-five percent of the revenue on capital gains is paid by taxpayers with more than $100,000 of adjusted gross income. This is shown on table 2.

Senator BOSCHWITZ. What table are you—where——

Dr. VASQUEZ. It is table 2 on page 9.

Senator BOSCHWITZ. Now say that last sentence, again.

Dr. VASQUEZ. There are four columns on the table.

Senator BOSCHWITZ. Yes.

Dr. VASQUEZ. In effect, what I am showing on this table is the percent distribution of capital gains, tax liability under the four tax schemes: Current law, the President's proposal, the House bill, and the Senate Finance Committee bill, and this is by adjusted gross income class.

If you look at the combined total for the $100,000 or more income class under current law there is 20.4 percent of the revenue is paid in the 100 to 200 class and 54.6 percent is paid by 200,000 and over. The combined total is 75 percent, which is, I believe, the number that has been used today.

Senator BOSCHWITZ. Are you saying there that 75 percent of the capital gains, of the taxes that we collect, are paid by people with incomes in excess of 100 grand?

Dr. VASQUEZ. That's correct.

Earlier witnesses had stated that we would change that distribution dramatically if we enacted the Senate Finance Committee bill. If you go over to the last column, the sum of the 100,000 to 200,000 and 200,000 and over class is 75.9 percent. There is almost no change whatsoever. And the reason for that is we tax realizations, not accruals. And in effect taxpayers will, indeed, respond and reduce the realizations and their shares of taxes will not go up.

The reason that the distribution does not change on table 2 is exactly the same reason that there is not a revenue effect. That concludes my statement, Mr. Chairman.

[The prepared statement of Dr. Vasquez follows:]

TESTIMONY OF DR. THOMAS E. VASQUEZ

PRESIDENT

POLICY ECONOMICS GROUP

BEFORE

THE SENATE SMALL BUSINESS COMMITTEE

FOR RELEASE UPON DELIVERY
EXPECTED AT: 9:30 AM
WEDNESDAY - JUNE 4, 1986

Mr. Chairman

It is my pleasure to be here today to testify on behalf of the Coalition for American Entrepreneurship as an expert witness on the effects of changes in capital gains tax rates on capital gains revenues. This is a subject with which I have considerable experience, both during my professional career at the U.S. Department of the Treasury and in my current role at The Policy Economics Group (formerly deSeve Economics).

At the Treasury, I worked as a staff economist in the Office of Tax Analysis from 1972 to 1976. From 1977 to 1983 I served in positions as Assistant Director and Deputy Director of that Office and directed a staff of economists in the preparation of estimates of the revenue effects of all tax proposals initiated by the Administration and the Congress. The revenue impact of changes in capital gains tax rates was one of the issues to which I devoted considerable time.

More recently, at The Policy Economics Group, I was retained by the Coalition for American Entrepreneurship to analyze the revenue impact of capital gains tax rate changes. During the last three months, we have worked extensively on this subject and produced a fully documented report. I would like to summarize the major conclusions from that report in my remarks and to introduce the full report into the record.

Methodology

In deciding on whether to sell an asset, taxpayers take into account the transaction costs of the sale. All else equal, the higher the transaction costs, the lower the likelihood that taxpayers will decide to sell. Since capital gains are taxed when realized (when the asset is sold), not when the gains accrue, one major transaction cost is the capital gains tax. This linkage of selling and the incurring of capital gains tax liability results in a well documented fact: higher capital gains tax rates result in lower realizations or sales. This effect is often referred to as the "lock-in" effect.

The difficulty in estimating the revenue impact of changes in the capital gain tax rate, then, is estimating the effect of the tax rate change on the level of realizations or sales. The research in this area over the last few years has converged to yield similar results. The two most recent studies are the September 1985 Treasury Report to Congress entitled the "Capital Gains Tax Reductions of 1978" and an NBER prepublication report by Lawrence B. Lindsey entitled "Rates, Realizations, and Revenues of Capital Gains". These reports draw very similar conclusions and in my judgment are the best available estimates of the magnitude of the "lock-in" effect.

The revenue estimates in my report are based on the behavioral response estimates in the Treasury study and the Policy Economics Group individual income tax micro-simulation model. The micro-simulation model is a system of data base and computer software that is patterned after the system used by the U.S. Treasury Department and the Joint Committee on Taxation. The data base is a file of about 300,000 tax returns that are statistically

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weighted to reflect the entire population of taxpayers. The computer software contains about 15,000 lines of code and is designed to replicate Federal and state tax liability under current law and under alternative tax structures. Our simulation model produces results that are nearly identical to those produced by the Treasury and Joint Committee on Taxation.

Behavioral responses must be separately coded in our model, just as they must be coded separately in the Treasury and Joint Committee models. In these cases, it is obviously possible to produce different results among the models. The effort undertaken for the Coalition for American Entrepreneurship was to use the results of the Treasury Study to determine the behavioral response for each individual taxpayer on our file. The revenue estimates shown on Table 1 are the result of this effort.

The Treasury study concluded that recently enacted reductions in the capital gains tax rate (the Revenue Act of 1978 and the Economic Recovery Act of 1981) induced "unlocking" capital gains that generated significant revenue increases over the short run and relatively small revenue increases or decreases in years subsequent to the transition period.

I confess that when I was at Treasury, I was among those in the profession who significantly underestimated the degree to which taxpayers would change their realization of gains in response to a tax rate change. Based on the information that we had available at that time, we did not expect the realizations response to be as great as it in fact turned out to be. Now, with the recent analysis of both the 1978 and 1981 changes in capital gains tax rates and the NBER report, the empirical evidence is clear: changes in capital gains tax rates have little effect on revenues because the static revenue effect of changes in tax rates is offset by changes in realizations of gains.

In our report, the analysis of proposed changes in capital gains taxation are disaggregated into three effects. The first two effects, (1) individual tax rate schedule changes and (2) reductions in the capital gains exclusion rate, are estimated under the "static" assumption that realizations are not affected by tax rate changes. The third effect is the revenue impact from the change in realizations induced by changes in the capital gains tax rate. As noted above, estimates of this effect used in our report are based on the Treasury study.

Revenue Estimates

For each of these three effects, our study reported the revenue effects for both the House bill (H.R. 3838) and the President's proposal. We have subsequently also estimated the comparable effects for the Senate Finance Committee proposal. Table 1 presents these estimated revenue effects. The results highlight the degree to which the static revenue effect of changes in capital gains tax rates is offset by the induced effect on capital gains realizations.

In the case of the House bill, which would increase the maximum individual capital gains tax rate from 20 percent under current law to 22 percent, the combined effect of changes in tax rate schedules and the reduction in the exclusion rate would increase revenues over the 1986 to 1990 period by $16.2 billion. However, the induced effect on realizations would reduce revenues by $16.0 billion, thereby offsetting 99 percent of the static revenue gain. The net result of the capital gains provisions of the House bill, therefore, is a deminimus revenue impact over the five-year period of $0.2 billion.

For the President's proposal, which would reduce the maximum rate from 20 percent to 17.5 percent, changes in tax rate schedules and the exclusion rate would, under static assumptions, reduce revenues by $2.9 billion over a five year period. This

Table 1

Net Effect of the Tax Reform Proposals on Tax Revenues from Capital Gains

($ billions)

	Year					Cumulative
	1986	1987	1988	1989	1990	1986 - 1990
President's Proposal						
Static Effect:						
Individual Rate Schedule Changes	-0.3	-1.7	-2.9	-3.2	-3.6	-11.8
Exclusion Rate Changes	0.3	1.3	2.2	2.4	2.7	8.9
Total, Static Effect	*	-0.4	-0.7	-0.8	-0.9	-2.9
Induced Effect 1/	0.1	0.5	0.9	0.7	0.8	2.9
Net Effect	0.1	0.1	0.2	-0.1	-0.1	*

	Year					Cumulative
	1986	1987	1988	1989	1990	1986 - 1990
Bill						
Static Effect:						
Individual Rate Schedule Changes	-0.3	-1.5	-2.5	-2.8	-3.1	-10.2
Exclusion Rate Changes	0.9	4.3	6.3	7.1	7.8	26.4
Total, Static Effect	0.6	2.8	3.8	4.3	4.7	16.2
Induced Effect 1/	-0.7	-3.1	-4.2	-3.8	-4.2	-16.0
Net Effect	-0.1	-0.3	-0.4	0.5	0.5	0.2

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Table 1

Net Effect of the Tax Reform Proposals on Tax Revenues from Capital Gains

($ billions)
(Con't)

	Year 1987	1988	1989	1990	1991	Cumulative 1987 -1991
Senate Finance Committee Bill						
Static Effect:						
Individual Rate Schedule Changes	-0.3	-1.5	-2.4	-2.7	-3.0	-9.9
Exclusion Rate Changes	2.3	11.5	18.9	21.0	23.7	77.5
Total, Static Effect	2.0	10.0	16.5	18.3	20.7	67.6
Induced Effect 1/	2.3	-10.3	24.8	-15.6	-17.3	-65.7
Net Effect	4.3	-0.2	-8.3	2.7	3.4	1.9

1/ Treasury and the Joint Committee on Taxation include induced effects in their estimates of the revenue effects of capital gains rate changes, but their estimates of the magnitude of these effects may differ somewhat from the magnitude shown above.

Note: Details may not add to totals due to rounding.

* Less than $50 million

revenue loss would be fully offset, however, by the increase in realizations that would be induced by the tax rate increase.

Finally, for the Senate Finance Committee bill, which would increase the maximum capital gains tax rate to 27 percent for most taxpayers and to 32 percent for some very high income taxpayers (due to recapture of tax savings associated with the 15 percent tax rate) the change in tax rate schedules and the exclusion rate would add $67.6 billion to revenues. However, 97 percent of this static revenue gain would be offset by the induced effect on realizations, producing a net effect of the Committee's change in capital gains treatment of $1.9 billion over the five-year period. Thus, if the current tax treatment of capital gains were restored, this is the approximate revenue loss to the Committee bill that could reasonably be anticipated.

It is impossible to tell from the Joint Committee on Taxation's report the amount that they have estimated for the revenue gain due to the Senate Finance Committee changes in capital gains tax treatment. This effect is included in their overall estimate of tax rate changes and is therefore not separately identified. If a five-year revenue gain significantly greater than the $1.9 billion has been estimated, I believe history will prove it wrong, just as history proved my capital gains estimates in 1978 to be wrong.

Distributional Effects

It is commonly believed that increases in capital gains taxes will increase the taxes of high income taxpayers disproportionately relative to other taxpayers. This believe is premised, no doubt, on the fact that the preponderance of capital gains taxes are in fact paid by high income taxpayers. This is demonstrated in Table 2, which shows that 75 percent of capital gains taxes paid under current law are paid by taxpayers with Adjusted Gross Income in excess of $100,000. In fact, because the induced effects on realizations tend to be greater for high income taxpayers, the net effect of changes in capital gains tax treatment under any of the three tax plans discussed above would have little impact on the overall distribution of tax burdens. This point is highlighted in Table 2, which shows the distribution of capital gains tax liability under each of the three plans after taking induced effects into account.

Conclusions

Let me then summarize very briefly, Mr. Chairman, the two major conclusions from our study that have a substantial bearing on the important tax reform legislation now before the Senate.

First, the provisions in this legislation that increase capital gains tax rates have little impact on revenues over the five-year period. The corollary to this is that returning to current law taxation of capital gains will not significantly alter the revenue neutrality of this legislation.

Second, changes in capital gains tax rates have little impact on the distribution of tax burdens among income classes because of the induced effects of these rate changes. Accordingly, returning to current law taxation of capital gains would not affect significantly the overall distribution of tax burden in the Senate Finance Committee bill.

That concludes my statement Mr. Chairman. I will be happy to answer any questions that the Committee might have.

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Table 2

Percent Distribution of Capital Gains Tax Liability Under Current Law And Alternative Tax Reform Plans Assuming Changes in Realizations

(1986 Levels of Income)

Adjusted Gross Income ($1,000's)	Current Law	President's Proposal	House Bill	Senate Finance Committee Bill
Less than 10	2.8%	3.0%	3.5%	1.3%
10 - 15	0.6	0.5	0.6	0.4
15 - 20	0.8	0.8	0.8	0.8
20 - 30	2.1	2.1	2.3	2.5
30 - 50	6.4	6.3	7.1	8.6
50 - 100	12.1	11.7	11.6	10.5
100 - 200	20.4	20.1	20.0	19.6
200 or More	54.6	55.5	54.1	56.3
Total	100.0%	100.0%	100.0%	100.0%

Senator **Boschwitz**. I thank you for the testimony, both of you gentlemen, and the tables.

Let me ask you, Mr. Lindsey. Let us presume that Senator Packwood is successful in obtaining 51 Senators to oppose all amendments. You know, in the Senate you vote aye or nay; you do not say I will vote for it but not for that section 106 and 109, I do not like so much, either. You have got to vote just yes or no. Let us presume the bill comes before us for final passage as it came out of the committee. If you were the Senator from Massachusetts—if you are a Republican I hope you run—but I do not want to mention your chances, but that does not matter. [Laughter.]

But how would you vote for the bill?

Mr. **Lindsey**. Senator, may I amend an answer to your previous question, first? Yes, I was a small businessman. It has been 11 years. In my summer job in college, I ran a hot dog stand, the ultimate in small business, and provided a job for myself and my college roommate.

Senator **Boschwitz**. Where did you run this?

Mr. **Lindsey**. In Bath, ME.

Senator **Boschwitz**. You should have extended it to lobsters. They are more popular up there, plus they are very competitive up there.

Mr. **Lindsey**. I just wanted to tell the truth for the record.

Senator **Boschwitz**. That is good to do.

Mr. **Lindsey**. It is old age and being an absented-minded professor that made me forget.

I guess, in answer to your question, I would vote for the Senate bill, but I believe that it obviously could be improved. I would not vote for the Senate bill if it involved a higher rate than what we are now seeing. But overall, I would vote for the Senate bill.

Senator **Boschwitz**. That is a great problem to me, as well. And I am afraid that it is going to come back from conference with a higher rate. And then they are going to say, well, that Rudy—he will vote for it for 28 if he will vote for it for 27, and then they will stretch it out to 29 or who knows what. They may lose Rudy.

Mr. **Lindsey**. It also includes a 32-percent rate. There is a 32-percent rate for the 90th to 99th percentiles of taxpayers, roughly, and if they go to a 28- or 29-percent rate, that 32-percent rate may become a 33- or 34-percent rate, and I think it would be more difficult to vote for the bill in that case.

Senator **Boschwitz**. I might say that I think that the 32 is blended in so that I feel that the Tax Code should make me hit the floor running a little harder in the morning. As I pull up my pants I do not think well, now I am in the $75,000 to a $145,000 bracket. It is actually 32 at the moment. I would actually have the 73 percent in mind that I am going to keep. So I think that it is a stimulative type of thing.

As a businessman, I actually expanded it a little further than you did. I was in the 70-percent rate for a number of years. The idea of a 27-percent rate is very attractive.

What about you, Dr. Vasquez? Having listened to your testimony on and appreciating your testimony on capital gains, let us say that you were faced, as I will be perhaps with a up-or-down vote on the bill as presented by the committee?

Dr Vasquez. I would vote for it. There are parts to the bill that I do not care very much for. The passive loss provision is one that I have problems with. I do not think we went far enough on IRA's.

Senator Boschwitz. What do you mean we did not go far enough on IRA's?

Dr. Vasquez. I think we could cut those back even further. And, of course, the capital gains provision in my mind does not make sense, in the context of using it as a revenue raiser, so that——

Senator Boschwitz. Why do you think we could have cut back further on the IRA's?

Dr. Vasquez. Well, it is an issue of whether or not you believe that the IRA proposal itself induces additional savings. And it is my view that it does not.

Senator Boschwitz. Mr. Lindsey, what is your view on that?

Mr. Lindsey. Well, I would have to defer to a colleague of mine at the Kennedy School at Harvard, David Wise, W-i-s-e. He did a study of the 1982 numbers and found that there was a net contribution to national saving from IRA's. So I would defer to him and differ from my colleague on the panel.

Senator Boschwitz. I find the IRA's to be quite an emotional issue. People almost look upon it as their Social Security and many young people do not think that they are going to collect Social Security and now we are removing the opportunity for them to provide a substitute.

I went around in my business and talked to the people in my business. I was surprised to find some people—secretaries and others—secretaries who were not married but had children who were divorced in one case—whose income I would think would not justify it, and she had an IRA. I am not sure she had it to the full extent of the $2,000.

I have also been influenced by your colleague, Dr. Feldstein, who said that if there is some shifting that is going on after 4 or 5 years, you know, that they have done shifted what they can shift and at some point you cannot go out and borrow $2,000 at a pop and no longer can deduct the interest. And now that you have $8,000 to $10,000 of short-term debt, finding the interest nondeductible and, you know, you have got to think twice about adding another $2,000.

So you are either going to save or not save, and the other accounts may be depleted by this point. So it may be that just after the mischief has been done of switching and borrowing, and so forth, just as we have gotten to the end of that, we are going to throw the proverbial baby out with the bath water. That is another thing I am not sure of.

Mr. Lindsey. I think the bill also enhances the efficiency of the IRA's in two ways. There are two reasons people might want to go for an IRA now. One is to have the long-term buildup tax free. The other is that they might temporarily be in a lower tax bracket after they retire They are not going to be in that situation under this bill.

So I think that the arbitraging of income from one year to the other, via the IRA's, will be diminished. And that is the inefficient portion of the IRA legislation as it now stands. So I think on net, the Senate Finance proposals will strengthen the efficiency of IRA's rather than diminish their efficiency.

Senator **Boschwitz**. Say that again?

Mr. **Lindsey**. Because most people are going to be in either the 15 or the 27 percent rate, there will be less opportunity to arbitrage. That is, there will be less opportunity to put your money in now at a high tax rate and take it out later at a low tax rate, which is one of the inefficient features of IRA's currently. We are getting rid of that feature, and we are keeping the efficient part of IRA's, from the point of view of national saving. We could keep the efficient part of IRA's, I think, by having just the two rates, which will improve the overall tradeoff on the IRA's.

Senator **Boschwitz**. Well, if there is no further discussion, the hearing is concluded.

[Whereupon, at 12:25 p.m. the hearing was adjourned.]

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